MARKET IMPERFECTIONS AND THE ROLE OF RENT REGULATIONS IN THE RESIDENTIAL RENTAL MARKET

by

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INTRODUCTION

In discussing the potential rationales for rent regulations, this study focuses on the immediate and long-term viability of the private rental market mechanism. Can the rental market solve the problems of the rental sector? Or have changing macroeconomic and socio-political conditions brought about a situation in which the rental market cannot function efficiently, and in which government intervention, including rent regulation, is therefore necessary?

Conventional analysis tends to treat rental housing as a fairly straightforward market commodity and the rental market as a fairly straightforward commodity market. Thus a fundamental assumption of many rental housing and rent regulation studies is that the rental market can function normally, if it is allowed to do so. However, an examination of the macroeconomic conditions of the 1970's and 1980's suggests that there are indeed a number of serious impediments to the functioning of the rental market. Rental market regulations and other forms of intervention have indeed become necessary, not because they are desirable in themselves but because of the constraints on the ability of the rental market to function normally.

In addition to recognizing current macroeconomic conditions, we must also recognize that the socio-political realities of the 1970's and 1980's have led to a broader definition of the social objectives associated with the provision and distribution of rental housing. Achievement of these non-market objectives often requires a trade-off with the efficient operation of the market that further contributes to the inability of the market to function normally.

Consideration of both the potential rationale for rent regulations and the specific nature of the regulations must take place within a realistic assessment of these current and likely future conditions. Given the conditions in which housing supply and demand must operate in the 1980's, it is important to critically re-examine some of the concepts underlying the perfect competition model as it applies to the rental market. We need to determine whether it is even possible to model and assess rental-housing policy using conventional competitive market models. Market failure may, in fact, be an essential element of a useful policy model.

This paper attempts to identify the range of factors that contribute to the failure of the rental market to operate efficiently and the role that rent regulations may play in addressing some of these problems. The paper is divided into two parts. The first examines the nature of the problems in the rental sector in general and in the operation of the private rental market in particular. The second part discusses the potential rationales for rent regulation.

Part 1 begins with a discussion of the nature and scope of rental housing problems today (Chapter 1), proceeds to a review of the reliability of the evidence that attributes many of these problems to rent regulation (Chapter 2), and ends with a consideration of the problems in the operation of the private rental market (Chapter 3). The lengthy third chapter is divided into four sections: an overview of the range of government intervention in housing markets in general, a review of the characteristics internal to the housing market that call into question the wisdom of treating housing as a normal market commodity, a discussion of five major external constraints on the operation of the rental market, and, finally, a brief consideration of the impact of

imposing broader social goals on the ability of housing to function as a market commodity.

Part 2 contains two chapters. Chapter 4 examines the range of policy and program options available for addressing the rental sector's problems, and Chapter 5 discusses four specific rationales for the rent regulation option. The four rationales identified for rent regulations are security of tenure, maintenance of the affordability of the existing rental stock, prevention of regressive income redistribution, and mediation of conflicts relating to rental tenure.

PART I. THE RENTAL HOUSING MARKET: PROBLEM OR SOLUTION?

1. Major Elements of the Rental Housing Problem

The rental housing problem has two related elements: (1) the gap between affordable rents and existing rents (whether they be market or regulated rents) and (2) the gap between existing rent levels and financial recovery rents. Before we proceed, it is important to define the four kinds of rent level referred to in this study: affordable rent, market rent, regulated rent, and financial recovery rent.

Affordable rent refers to the largely subjective determination of some level at which households have a problem paying for their accommodation. Affordability is determined by comparing the relationship between a household's housing costs and its income with an assessment of what the relationship between housing costs and income ought to be. An affordability problem is said to exist if housing costs are judged to be "too large" a portion of household income. Rent-to-income ratios are the measures most often used to define affordability. The Canada Mortgage and Housing Corporation has recently begun using a "core housing need" approach in defining households with affordability problems. Both of these approaches are discussed below.

Market rent refers to the private-market-determined price of a rental unit. This is the rent established by the market in the absence of rent regulations. Regulated rent refers to the rent that prevails in a market in which binding rent regulations are in effect. The regulations override the market determination of rent levels. Where rent regulations prevail, the regulated rents become the market rents in the ordinary sense of the term, in that they are the rents that exist in the

rental market. In this study, however, the term "market rent" refers only to the rent levels that exist or would exist in the absence of rent regulations. The term "existing rents" is used to refer to the rents that currently exist, whether they are regulated or not.

Financial recovery rent refers to the rent level necessary to make new construction profitable in the absence of government supply subsidies. It is the rent that must be charged in order to make private rental investment attractive. This does not mean that the existing stock and newly constructed stock must have similar rent levels. There is usually a gap that reflects the differences in quality between new and existing units. However, the gap between the rent levels of the existing stock and the newly constructed stock must not exceed the premium that households are willing or able to pay for new units. If it does exceed this premium, the new stock will be difficult to rent, regardless of the vacancy rate. The price and profit signals provided by the existing stock must accurately reflect relative profitability if investors are to be interested in building new units.

1.1 The Gap Between Affordable Rents and Existing Rents

Many low- and moderate-income households cannot find affordable accommodation in the private rental sector. Though the definition of affordability varies from study to study, it is generally agreed that a substantial minority of tenants have to spend an "unreasonable" amount of their household income on rent. Traditionally, an expenditure on housing in excess of 25 per cent or 30 per cent of household income is considered unaffordable.

There are many problems associated with measuring exactly how great the "affordability gap" is among tenant households. The gap to be

measured is that between what is determined to be affordable (the affordable rent) and what the household must pay (the market or regulated rent). CMHC has estimated that, as of 1980, about 18 per cent of all tenant households were in the "core housing need" category. This means that 520,000 tenant households, 180,000 of them in Ontario, were experiencing housing affordability problems in 1980 (CMHC 1983, 41). The term "core housing need" refers to lower-income households that spend more than 30 per cent of household income on rent. Though still a flawed approach to defining the affordability gap, this formula does at least leave out of the reckoning those households with high incomes that choose to spend a high percentage of their incomes on rent. Most definitions of affordability are based on the rent-to-income ratio alone -- that is, they simply define anyone who spends more than a certain percentage of income on shelter as having an affordability problem.

Because of the need to select a cut-off point, any definition of affordability is essentially arbitrary. However, no matter what cut-off point one chooses, it is clear that housing affordability is a serious and large-scale problem among tenant households in Canada. The various attempts to quantify the extent of the affordability problem conclude that, whatever the cut-off point, the percentage of tenants experiencing problems is in the 15 to 30 per cent range. The scope of the problem has not been well documented for specific urban areas (i.e., on a disaggregated basis). Recent empirical studies of affordability in Ontario include the Metropolitan Toronto Planning Department (1980 and 1983), Miron (1981), Social Planning Council of Metropolitan Toronto (1982a), and Social Planning Council of Oshawa-Whitby (1981).

Because rent regulations have been in place in most provinces for much of the past decade, recent studies of the affordability problem

generally measure the gap between affordable rent and regulated rent. To the extent that rent regulations have kept rents lower than they would otherwise be, the use of regulated rents to measure affordability problems has understated the extent of the affordability problem. If regulated rents are indeed lower than market rents would be, then the gap between affordable rents and market rents would be greater than the gap between affordable rents and regulated rents, and would place more tenant households in the "core housing need" category in the absence of government intervention. This often-overlooked element of the housing affordability question is crucial to the assessment of rent regulation. In considering the maintenance of rental stock affordability as one of the potential rationales for rent regulation, we need to measure the gap between affordable rents and market rents. According to some of the arguments in favour of rent regulations, it is because of this gap that we have implemented rent controls as one admittedly imperfect method of maintaining the affordability of the existing rental stock.

However, many economists argue that affordability is primarily a problem of income distribution, and that it would be better handled by direct cash transfers (see, for example, Goldberg 1983 and Clayton Research 1984). The problem with this view is that the social objectives associated with housing involve more than just income redistribution. The quantity, quality, and location of the housing consumed by lower-income households are often of concern. For example, many municipalities are concerned about social mix; in particular, they wish to prevent the concentration of households with potentially problematic characteristics and to provide better access for a broader range of household types to a city's different neighbourhoods (see, for

example, Association of Municipalities of Ontario 1981, 16-18). Given such concerns, rent regulations have the potential of maintaining a greater degree of affordability within the existing stock, while assisted housing programs add affordable units to the existing stock.

1.2 The Gap Between Existing Rents and Financial Recovery Rents

In addition to the inability of the market to supply housing to many low- and moderate-income households -- the gap between affordable rents and existing rents -- a second gap has become very serious in recent years. This is the gap between the rents that tenants are either able or willing to pay (existing rents, whether regulated rents or market rents), and the rents necessary to build new units on a profitable basis (financial recovery rents, sometimes called economic rents). In an equilibrium market, price (market rents, in this case) should correspond to marginal cost (financial recovery rent, after allowing for inflation). However, there is reason to believe that the rental housing market has not been in equilibrium since at least the early 1970's.

The gap between market rents and financial recovery rents in the current market has become very large in most of the major metropolitan centres. Whereas the current rent for an average two-bedroom unit is generally $500 to $600, the rent for such a unit necessary to finance new rental projects is estimated to be $800 to $1,000. The nature and extent of this gap is discussed in Clayton Research (1984, 10-14). The size of the gap varies from market to market, and it fluctuates in response to changes in the numerous factors affecting the investment and construction markets. This gap likely existed before the introduction of rent regulations, though it was probably not as great and did not fluctuate as much as it appears to have done in recent years.

While it is not yet clear exactly why the gap has developed, interest rates have likely played a major role in causing both the gap and the fluctuations in the gap. Fluctuations in real long-term interest rates cause substantial fluctuations in financial recovery rent levels, which in turn imply similar fluctuations in market rents in uncontrolled markets where demand is growing. The fact that real long-term interest rates are at abnormally high levels introduces a potential rationale for regulation, which might help maintain a more stable rental market.

Federal rental supply subsidies are another likely cause of fluctuations in financial recovery rent levels. When construction is subsidized, financial recovery rent levels are reduced. If the subsidies are suddenly removed, financial recovery rent levels and hence market rents will, obviously, rise sharply in growing markets. Federal rental housing programs over the past fifteen years can best be described as "random". Every few years a program is introduced or abolished. The major ones have included: the 1971 tax changes affecting rental investment benefits; MURB tax benefits, which have been turned on and off more than once since being introduced in the November 1974 budget; the Assisted Rental Program, which was in place from 1975 to 1978; and the Canada Rental Supply Program, which was introduced in the November 1981 budget.

Regardless of the merits of any of these programs, their contribution to the volatility of financial recovery rent levels has had a significant social cost. Even the strongest opponent of government intervention through rent regulations must recognize that random subsidy policies are a potentially serious source of market distortions. Among other things, they increase the risks associated with predicting future

market conditions. Since a provincial government cannot easily change federal housing programs, it must take their erratic nature as a given. Whether or not it should intervene therefore becomes a "second best" problem. The ideal solution, whether one believes it is no government intervention or implementation of a consistent long-term government housing strategy, does not appear very likely to be achieved, and in any case its accomplishment is generally beyond the power of a provincial government.

It is frequently argued that regulated rents should be abolished in order to permit market rents to rise closer to financial recovery rents. Such a rise would presumably encourage a large-scale renewal of private investment in rental housing (see, for example, Clayton Research 1984, Economic Council of Canada 1982 and 1983). There are a number of grounds on which the feasibility of this scenario can be called into question.

For one thing, investors would quite likely be concerned about the reintroduction of rent controls even if they were removed. Furthermore, even though we do know what it costs to build a rental unit of modest quality (either from developers currently building such units or from CMHC's determination of maximum unit prices for the non-profit and co-op housing projects it assists in each market area), we do not know and probably cannot assume that a return to market rents would be enough to make financial recovery rents viable. How many tenants would be able or willing to pay the higher rents? The demand pressure for rental accommodation appears to come largely from lower-income households, such as single parents, singles, and the elderly. Unfortunately, very little research has been done on the housing demand question (see Miron 1983 for a review of the available theoretical and empirical literature).

In addition to these issues, there is the difficult question of how developers make investment decisions and generate investment funds for the residential rental market in the unstable macroeconomic and mortgage interest rate environment of the 1980's. There appears to have been a substantial shift from residential investment to commercial investment among the larger real estate developers and investors. Will the most experienced larger development firms begin to make major investments in the residential rental market again? How "good" must rental market investment conditions be for them to return?

Certainly the present gap between existing and financial recovery rents is so large that non-subsidized rental investment in lower income housing is virtually impossible in the major urban centres, although the market can still supply units aimed at the small percentage of higher income tenants. However, very little research has been done to determine the size of this gap for each market area. We also need to examine tenant household incomes to determine what percentage of tenants could afford rents that would begin to narrow the gap between existing rents and financial recovery rents. There would always be some gap, since new units attract higher market rents than existing units. The concern is that a very high percentage of tenants, perhaps a majority, would not be able to afford rents at the higher levels. If rent levels in the existing stock began to approach the rents necessary in unsubsidized newly built projects, even more tenants would be forced into the category of those with affordability problems. This outcome would be avoided only if the real incomes of tenant households kept pace with real increases in rents.

1.3 Is the Rental Market the Problem or the Solution?

The conventional assumption is that the problems of the rental sector are simply a temporary aberration in the performance of the private market mechanism. Conventional assumption is that the problems of the rental sector represent not a failure of the market mechanism as such, but rather a failure of government policy to allow that mechanism to function. If government policy created the right conditions, the private market could solve the problems of the rental sector. This hypothesis has been argued in a number of recent studies (for example, Clayton Research 1984, Goldberg 1983, Jones 1983, and Smith 1983).

We do not, however, have sufficient data on the housing market to empirically test many of the common assumptions about the manner in which various factors affect rental market dynamics. Consequently, housing analysts fall back on theories of how markets in general should ideally operate. Using the assumptions built into theories about ideal markets, they arrive at a definition of the problem and a prescription for its solution. What they rarely discuss in an explicit fashion are the starting assumptions about the performance of the rental market mechanism.

Rental housing is an extremely complex good: numerous factors both internal and external to the dynamics of the rental market mechanism influence supply and demand. One purpose of theory is to provide a structured explanation of realities that are too complex for easy empirical analysis. Can we in fact apply the theories of conventional economic analysis to the realities of the rental housing sector in the Canada of the 1980's? While it is too early to give a firm, verifiable answer to this question, the issues raised below would

seem at least to call into doubt the assumptions upon which conventional notions about rental housing performance are based. There may now be long-term structural impediments to the functioning of the market that require various forms of government intervention, including rent regulations. The following chapter reviews the reliability of the evidence offered thus far on behalf of the assumption that the rental market has not failed but that government regulations, in particular rent regulations, have caused many of the problems we are now experiencing. This section is followed by a discussion of the range of potential problematic characteristics of the rental market that may be contributing to the failure of the private market mechanism to function.

2. Measuring the Market Impacts of Rent Regulations

What evidence is there for the hypothesis that rent regulations have played a major role in bringing about rental sector problems? How adequate and reliable is the evidence? It is important to review some of the shortcomings of this fairly widespread belief. If rent regulations were the cause of many of the rental sector's problems, we would not need to proceed much further with our examination of potential market imperfections.

2.1 The Lack of Reliable Evidence

Different studies of rent controls have produced radically different results, making rent regulation one of the more controversial forms of government intervention. Hard evidence about impacts is often scanty, and arguments tend to be put forward with an intensity that is in inverse ratio to the amount of evidence. There is a surprising lack of adequate performance data that can be used to evaluate rent regulations. Although researchers tend to fully note that there is little hard evidence necessary for basing detailed conclusions about impacts, some still go ahead and draw sweeping conclusions. Due to the lack of adequate data, researchers are forced to rely on numerous assumptions and short cuts that, all too often seriously compromise the reliability of the conclusions. A vast body of literature has developed to demonstrate the supposed harmfulness or value of rent regulation. On what evidence is this literature based?

In their recent review of this research, Miron and Cullingworth argue that

> the evidence is inadequate, that much of it admits to plausible alternative interpretations, and that an informed decision about the future of Rent Review requires much better data than have been collected to date. (1983, 20)

Researchers, they point out, encounter two fundamental methodological problems in attempting to analyse the potential impact of rent regulations: (1) the counterscenario problem and (2) the impact domain problem.

The Counterscenario. An "impact" is a difference between two scenarios: the one being witnessed and another, the counterscenario, that we would now be seeing if the policy under examination had not been enacted. What, for example, might rents, housing prices, construction activity, and so on look like today if rent review had not been implemented? Common methods used to specify a counterscenario are temporal comparison, cross-sectional comparison and model simulation. Model simulation of the impacts of rent review would require a large working model of Ontario's housing market, but no such model exists. (Ibid., 21).

The Impact Domain Problem. The counterscenario may be different from the Ontario we now see. However, it may not be necessary to empirically measure every difference between the two scenarios, since some of the differences may not be very important. The question of which impacts are important and which are not is a key problem (the "impact domain" problem). Some economists restrict the impact domain to impacts on economic efficiency and, at that, usually only under the strict assumption of an economy in competitive equilibrium. Others prefer to consider impacts in a wider domain and under less restrictive assumptions. As Miron and Cullingworth note:

> Many of these studies take fairly limited views of the priorities among different social goals. Although valuable in their own right, they emphasize the importance of economic efficiency and, less frequently, income redistribution. Though they commonly conclude that rent control is bad because it is inefficient or a blunt tool for income redistribution, these studies are typically based on skimpy data and ignore other societal goals. (Ibid., 4)

2.2 Unsupportable Negative Impact Claims

Miron and Cullingworth conclude that there simply isn't reliable evidence that rent controls have produced the range of negative impacts commonly attributed to them. The impacts must be assessed on a case by case basis, taking into account (1) local market conditions and (2) the specific regulations of the system under examination, including the system's loopholes and inconsistencies. Currently available evidence is inadequate to support firm assessments. Miron and Cullingworth list the following reasons why this is the case:

- These impact data often are consistent with contradictory interpretations.
- They are often based on crude counterfactual speculations: comparing areas before and after rent control or comparing areas with rent controls to non-controlled areas without controlling for other differences between such areas.
- Much of the available literature implicitly assumes that economic efficiency is the only societal goal of relevance to Rent Review. There are widespread allegations that Rent Review creates economic inefficiency and these may well be correct. However, there are no measures available of the overall loss in economic efficiency. Estimates abound of how much rents are depressed or how low construction volumes are but these do not directly measure the efficiency loss.
- It is one thing to argue that Rent Review creates economic inefficiency and quite another to argue that it is socially undesirable. A

> rational public debate requires a careful assessment of all the impacts of Rent Review in the context of the set of societal goals as perceived by each individual. (Ibid., 40)

Reviews of the U.S. rent control impact literature cite the following additional reasons for the inadequacy of existing assessments of rent regulation:

> Many of the studies have been undertaken in the early stages of rent control when it is difficult to judge the impact on the local housing market because data is difficult to obtain and a host of other factors may be influential. (Keating 1983, 13)

> The impact of controls varies according to economic and social conditions in particular cities. Some cities, for example, have growth-restricting land use regulations which contribute to an inadequate supply of land zoned for rental projects. This can be a major contributor to increased rents and decreased supply even without rent regulations. In other municipalities, or municipal jurisdictions within metropolitan areas, locational advantages may be a factor in forcing demand to be greater than the supply response, again forcing up rents. (Gilderbloom and Friends 1981, 45-46)

> Rent control measures differ quite markedly in terms of their impact on tenants and landlords. It is not useful or accurate to discuss the impact of rent regulations in a blanket way without a thorough examination of these differences. (Rea and Gupta 1982, 109)

> It is very difficult to separate the effects of rent regulations from demographic and social changes. (Stegman, 29)

> The impact of controls depends very much on the kind of controls imposed. Second generation rent regulations have their strong, moderate and weak variations. Each, however, has its own peculiar rules and regulations. It is virtually impossible for one jurisdiction to adopt the exact rent regulation approach of another. There does not exist at this time a model second generation rent control law that even approaches universal application. (Harvey 1981, 81)

Researchers disagree seriously about the impacts of rent

regulation partly because the virtual impossibility of collecting data capable of covering the essential variables (assuming we can identify the essential variables) forces them to use numerous, usually inadequate, proxies. In the absence of empirical evidence, theory and models must carry the burden of analysis.

The major determinants of the way in which rent regulations are analysed appear to be (1) one's views about the current and likely future health and viability of the private rental market mechanism and (2) one's views about the role of government intervention in general. Many economists who write about rental housing issues take the efficiency of the unregulated rental market for granted. It is an unquestioned, unresearched starting point. In addition, they assume that the market for rental housing is little different than the markets for other commodities. These crucial assumptions are reviewed in the next chapter.

Another common assumption is that "objective" research and quantitative data can resolve value-laden public policy issues. For example, Arnott's recent study of options for rent decontrol in Ontario states the following proposition: "A policy issue can rarely, if ever, be resolved in a wholly satisfactory way on the basis of a priori, qualitative reasoning alone. Rather, the pros and cons should be quantified to determine whether the dollar benefits of a given policy exceed its dollar costs" (Arnott 1981, 29). Thus we are told that quantitative data of one type, the economic costs and benefits, will provide us with the "right answer" as to which policy option should be selected.

Finally, many economists assume that it is practically as well

as theoretically possible to resolve the issue of rent regulation: they overlook the arbitrary nature of their assessment criteria and the unreliability of the data to put forth their conclusions and recommendations as though they were definitive. Miron and Cullingworth (1983) cite a recent article by Smith and Tomlinson that draws sweeping conclusions about Ontario's rent regulation system:

> Rent control in Ontario has significantly reduced the real (and to a lesser extent the nominal) value of rental apartment dwellings, substantially inhibited new rental construction, generated rental shortages, created a dual controlled and uncontrolled rental market in which rents in the uncontrolled sector are higher than they would have been in the absence of controls, encouraged deterioration in the quality of the existing housing stock and imposed a large revenue and expenditure cost on government and hence on the non-rent controlled public. (1981, 111)

Miron and Cullingworth argue that there "is very little hard, unambiguous evidence to support such conclusions" (1983, 40). They do not deny that there may be impacts such as those described by Smith and Tomlinson; rather they convincingly argue that it

> is not at all clear that Rent Review has been harmful to Ontario to date. There is, however, also little evidence that Rent Review has been successful in achieving the goals its proponents might argue are important. (Ibid.)

Arnott also concludes that rent regulations have numerous negative impacts. However, he does admit that, at the empirical level, there is little reliable evidence to support these conclusions, which he bases largely on theories about how markets ought to function.

> How large an impact are controls having on the Ontario housing market? The short answer is that it is very difficult to tell....the evidence is inconclusive. (1981, 105)

> Thus, while it appears likely that controls have had an impact on Ontario's housing market, this impact has not been so substantial that the changes in the market from 1975 to 1979 could not be explained by other factors. (Ibid., 107)

Keating's recent review of the rent control experience of California draws similar conclusions about the rent regulation impact assessment literature:

> As yet, there is no convincing evidence that short-term local rent controls have directly caused any of the alleged negative effects of rent control, for example, reduction in the supply of rental housing because of noninvestment in new construction; conversion of rental units and abandonment; poor maintenance; or reduced tenant mobility and unit turnover. (1983, 18)

Keating makes special mention of studies of the impact of rent control in Los Angeles. A 1981 Rand Corporation study concluded that there was no rental housing crisis in Los Angeles and therefore no need for rent controls (Rydell et al. 1981). The Rand conclusion was highly controversial because a 1980 UCLA study of the rental situation had found a virtually zero vacancy rate and concluded that a rental crisis did exist (Clark et al. 1980). Yet another critical study of rent control concluded in 1982 that there was a serious rental problem and that it was caused by the existence of rent controls (Chapman 1982). Faced with these conflicting studies, Los Angeles extended rent control indefinitely, with an evaluation to be carried out in 1986 (Keating 1983, 12).

Many of the U.S. studies and press accounts claiming that there are numerous adverse consequences of moderate rent control cite the work of George Sternlieb. However, Dreier et al. note that the methods Sternlieb uses for reaching his conclusions leave a lot to be desired:

> A close examination of Sternlieb's studies, however, reveals serious shortcomings that serve to bias their results, calling into question the conclusions of the many technical and popular reports that are based on his findings. Principal among these defects is the failure to examine systematically a comparable set of rent- and non rent-controlled cities, and - in those few studies that attempt such comparisons - the failure to control adequately for potentially confounding effects. (1980, 156)

Gilderbloom et al. conclude that there is no hard evidence for the host of negative impact claims one finds in the U.S. literature on the impacts of moderate rent control.

> This article finds no evidence to support the contention that moderate rent control over a three to five year period has led to a reduction in multi-family residential construction, a decline in maintenance, an erosion of the tax base relative to non-rent controlled cities, or an increase in abandonments or demolitions. Those studies arguing the reverse are characterized by data rendered suspect because of the non-representative sampling and highly selective statistics. While all available data suggest that short term moderate controls have no measurable negative impact, this does not imply that such relationships exist. More research is needed to study the long term effects of moderate control. (1981, 123)

The major point here is that we have a long way to go before we even begin to have enough hard, reliable evidence about the magnitude of the real, as opposed to the assumed or theoretical, impacts of moderate rent regulations. A few years' experience is not enough upon which to develop data and draw reliable conclusions. We can list what the categories of economic costs might be but we do not know whether the actual costs are large enough to offset the social benefits realized -- assuming that we can in fact effectively measure both the economic and social costs and benefits.

2.3 Why Are Rent Regulations So Controversial?

There appear to be several reasons for the controversial nature of rent regulation: (1) ideological differences (in particular, different assumptions about government intervention and the performance of the private rental market), (2) a lack of agreement about what the specific goals of public policy should be, (3) misunderstandings about the nature of the existing rent regulation system, (4) assumptions about the actual impacts and effectiveness of rent regulations, and, finally, (5) economic self-interest.

Ideology. The rent regulation issue pits those who oppose public sector intervention in a market economy against those who feel that some forms of intervention are justifiable on both economic and broader social grounds, even though there may be some costs involved in terms of the efficiency of the private market mechanism. The ideological quarrel usually manifests itself as a disagreement over what "the facts" are and over which facts are the most relevant or significant.

Little Agreement on Social Priorities. Opponents of rent regulations argue that they inevitably involve economic inefficiencies. Proponents may accept that rent regulations involve economic inefficiencies but argue that they promote social goals more important than economic efficiency. In our democratic society, it is up to the elected representatives to make the final decision. These decisions are not necessarily based on the most rational arguments or the most significant empirical research. As Miron and Cullingworth note:

> The issues are seen to be complex and particularly troublesome for politicians. Economic wisdom does not always point in the same direction as the

> dictates of social justice; and political expediency may lead in another direction. (1983, 17-18)

Given these political realities, it is difficult to imagine that a form of intervention such as rent regulation could ever become non-controversial.

Misunderstandings about the Nature of the Existing Rent Regulation System. There are many different versions of rent regulation in use today. Each version is designed to achieve certain objectives within the jurisdiction that adopts the legislation. Given the controversial nature of rent regulation, it is inevitable that any system will be a compromise between the ideal positions of the opposing groups. Neither side will achieve all of its objectives, and it is unlikely that both sides will accept the compromise as a just and reasonable one. Each side has its own expectations about the operation and outcomes of the rent regulation system. There can be little doubt that numerous misunderstandings about the nature, objectives, and impacts of rent regulation and about what rent regulation can and cannot achieve have clouded the debate on the subject.

Assumptions about the Actual Impacts and Effectiveness of Rent Regulation. Debate over the impact of rent regulations usually assumes that the regulations are effectively administered. In fact, like any other system of regulation, rent regulation is open to abuse: there are usually any number of ways to avoid some or even all of the regulations. Effectiveness depends in part upon the adequacy of the staffing and funding of the controlling agency. Understaffing and underfunding can only reduce the effectiveness of any regulatory agency. The difference between what ought to be occurring and the reality of what the agents

attempting to implement the regulations are actually able to do is another fruitful source of controversy.

Economic Self-Interest. Finally, the economic well-being of both landlords and tenants is directly affected by rent regulations, a circumstance that provides both groups with more than enough of an incentive to take positions and lobby government on their own behalf.

Most forms of government regulation come about as the result of pressures from readily identifiable interest groups. Interest groups organize in our democratic society in order to seek redress for unfair or discriminatory practices or to further their economic interests. In other words, groups seek or oppose regulations in order to protect or create entrenched positions. Politicians seeking the support -- or the pacification -- of interest groups supply the necessary legislation. Rent regulation provides a classic case of unavoidable conflict between two powerful interests, conflict in which both sides have reasonably good cases to make and in which one side gains certain rights and benefits at the direct expense of the other.

3. Problematic Characteristics of the Residential Rental Market

It is important that a discussion of one form of government intervention in housing markets, rent regulations, be placed in context with the full range of government interventions in housing. Consequently this chapter begins by reviewing the history of government's role in the rental sector. The most relevant question here is why: why has government intervened so extensively in housing markets? The stage is then set for a discussion of the characteristics of housing, both internal and external to the housing market, that in fact prevent it from functioning as a normal market commodity. The chapter ends with a discussion of the impact of societal goals on the housing market.

The general argument here is that the market mechanism for rental housing is very imperfect and that factors both internal and external to the operation of the rental market have contributed to the serious problems we now face. It is much too simple to conclude that government intervention is the villain and that a private rental market free of major forms of government intervention is a feasible solution in the 1980's and beyond. Even if this solution were feasible, general social concerns about the provision of housing would likely make it undesirable and therefore politically unacceptable. We are left with an admittedly imperfect mix of public and private actors to provide and maintain rental housing. This has been the case since long before the introduction of rent regulations. In the circumstances, rental housing problems can be addressed only by seeking the mix of public and private activities that provides and maintains the required stock of rental housing in the most efficient and socially acceptable way, given the social, political, and economic realities of the day.

3.1 The Role of Government in the Rental Sector

There has traditionally been a great deal of government intervention in Canada's rental housing sector. This history of intervention reflects the widespread acceptance of the importance of housing in the private and community lives of Canadians. It also reflects an evolving view of the appropriate mix of the private and public sectors in housing and urban development. Left to itself, the price mechanism has been unable to meet the broad set of housing-related objectives and land use patterns deemed, rightly or wrongly, desirable to society. Intervention in housing has grown without significant interruption over a span of decades; all three levels of government and all the major political parties have had a hand in it. Saywell offers the following overview of the evolving rationale for public policy in the housing sector.

> Public policy on housing was slow to develop, contenting itself with building and zoning regulations to protect the health and welfare of the community against fire and disease and, occasionally, protecting the upper middle class against the environmental ravages of low income housing. All levels of government sought to maximize absolute growth, and municipalities lavished attention and aid on new industries assuming that the market would supply the housing. Although the evidence of market failure was apparent before 1914, and there were a few gestures towards remedial action, it was not until the end of the depression that public policy seriously developed. Initially, state intervention in the housing field was seen simply as an employment-generating mechanism, although by 1945 the beginnings of a social policy could be seen. Thirty years later housing policy to most Canadians remained a baffling mixture of economic and social policy, an embarrassing and paradoxical presence of housing poverty in the midst of economic plenty, and a case study in the complexity of modern commodity production as analysts identified upwards of one hundred human links in the chain which led from land acquisition to the final purchase of a house. (1975, v-vi)

For an account of the evolution and the extent of intervention, see, for example, Hamilton (1981), Hulchanski (1981), Rose (1980), and Saywell (1975).

Government intervention both improved the quality of the housing stock and contributed to the rising cost of housing. Initially, local government regulated the health, safety, fire, and construction standards of housing. It gradually added a host of land use and development regulations. Unhealthy, unsafe, and poor quality urban housing were largely eliminated. As the standards of housing improved, however, an increasing minority of households found they could not afford the housing provided by the private market. It was becoming too expensive for households with low incomes.

It is important to note that the failure of the market to meet the housing needs of low-income households cannot be simply attributed to the the market itself. The history of the provision of housing in Canada has been one in which the government has played a major role. Intervention has sought at times to assist the functioning of the market, whether or not it actually achieved this end, and at other times it has sought to achieve goals that conflict with the market's ability to function efficiently. It would be difficult to identify a time when we had a completely laissez faire housing market. Some of the earliest municipal bylaws regulate building standards.

Nonetheless, the private sector has generally not been able to provide adequate housing for low-income groups. As the Association of Municipalities of Ontario (AMO) notes in a recent housing policy paper, government has had to intervene and must continue its intervention in order to address the private sector's inability to meet the housing needs of low-income households.

> Implicit in the continuity of government involvement in housing has been the inability of the private sector to provide housing for low-income people in this country. Although many of the early Federal initiatives were designed to relieve a shortage problem, Federal incentives were introduced as early as 1938, through The National Housing Act, to stimulate the development of low-income rental projects. Decreasing interest by the private sector in limited dividend housing, however, led to the establishment of legislation in the late 1940's enabling direct government development of public housing. Since that time, private industry in this country has basically not attempted, nor is it able, to provide appropriate housing for low-income people. In recent years ... responsibility for the development of low-income housing has fallen entirely to government and non-profit and cooperative housing producers. (1981, 7-8)

In response to the inability of the market to meet all housing needs, government social welfare programs began to include a housing allowance component for those on welfare, and after the Second World War the federal government introduced two rental housing programs: the Limited Dividend Program offered investment incentives to the private sector for the construction of modest quality rental units, and local and provincial housing corporations received funding for publicly owned housing. These programs gradually developed into the two current types of federal rental housing supply schemes: (1) the programs made available from time to time to private sector builders (the Assisted Rental Program and the Canada Rental Supply Program) and (2) the municipal, private, and co-operative non-profit housing programs made available under Section 56.1 of the National Housing Act. In addition to these direct subsidies, the federal government provides various indirect subsidies, they range from federally insured mortgages to the housing investment tax benefits. Thus Canada, like most developed nations, has taken the view that housing is, up to a point, a social responsibility that should not be left entirely to the free play of market forces.

Over the past two decades, concern over security of tenure and due process in the rental housing sector has led to the adoption of two more types of regulatory measures. Most provinces adopted landlord and tenant legislation during the early 1970's, and concern over the impact of inflation led to the imposition of rent regulations as part of the wage and price controls of the mid-1970's.

From the late nineteenth century to the present, therefore, the rental housing market in Canada has incorporated a wide range of government-imposed regulatory measures and government-subsidized supply programs. Instead of a typical free market, we have had a mixture of public and private sector roles in the provision and maintenance of the rental stock. This situation is in keeping with the two general concerns that housing policy has addressed through the years, the supply objective and the equity objective. The supply objective refers to the concern with producing an adequate level of investment in housing, a concern over both the size and quality of the housing stock. The equity objective relates to the distribution of that investment. All households ought to have access to housing appropriate to their needs. However, expressing these aims in such general terms leaves open the question of the nature and degree of intervention necessary to meet them.

The role of government in housing, like its role in many other areas of social and economic policy, has been and remains a matter of controversy. Lansley notes that it is possible to identify three distinct views about government intervention in housing:

1. Housing markets should be allowed to operate freely with little or no intervention.

2. There is a substantial role for both public intervention and the private market, with governments involved in setting standards, in providing subsidies, in exercising control over various aspects of housing supply and demand, and in the direct provision of housing, with private market dynamics having free rein within these constraints.

3. There should be a much more comprehensive role for government, with a more extensively controlled and socialized market. (1979, 18)

Public opinion, and the practice of our elected officials at all levels of government as well, places the majority view of our society in the second category. In recent years, public opinion has also tended to favour the imposition and maintenance of a variety of new regulatory measures aimed specifically at the operation of the private rental market.

Why has there been such extensive intervention in the rental market? There seem to be two basic rationales:

1. the need to correct the real or perceived failings of the private rental market;

2. the desire to achieve certain social objectives.

In technical terms, the first rationale refers to the market's failure to be allocatively "efficient" in terms of the supply and demand aspects of rental housing as a market commodity. The second rationale refers to the political decision in a democracy to achieve certain social objectives even if this means making a trade-off with the efficient operation of the market.

3.2 Problematic Characteristics of Housing as a Market Commodity

In the housing market, and particularly the rental market, there are significant impediments that can prevent the conditions necessary for a market to be competitive and efficient. Factors exist that can change the signals provided by prices, costs, and profits that households and firms receive and respond to, with the result that the market operates inefficiently:

> It is evident that the housing market is far from a perfect competitive market. First, most advocates of rent control believe that landlords influence rents, and in fact they do have some monopoly power. Second, all agents are not equally well informed.... Third, transactions costs -- in this context, moving and search costs --are significant. (Arnott 1981, 19.)

Though such imperfections in the housing market are generally recognized, some analysts proceed on the assumption that they are either not serious or that they can be overcome. This is one reason why housing analysts disagree about the impacts of and rationales for rent regulations.

Unfortunately, there is not much literature on the real constraints acting on the rental market in general and the Canadian rental market in particular. There are a number of crucial conditions that must be met in order for any market to be competitive and, therefore, efficient. The conditions most often mentioned in the literature are the following:

1. no economic agent or group of agents can influence prices;
2. there are no barriers to entry or exit from the market;

3. all agents are equally well-informed;

4. transactions costs are negligible.

As the discussion below will attempt to demonstrate, the rental housing market fails to fully satisfy any of these criteria for efficiency. However, many of the problematic characteristics of the housing market defined in the discussion are by no means unique to that market. It is the combination of these problematic characteristics, and not any one of them, that makes housing a unique commodity. By the same token, it is the combined effect of these characteristics, rather than the effect of any one of them, that accounts for the failure of the housing market.

In view of the conditions in which housing supply and demand operate in the 1980's, it is important to critically re-examine some of the underlying concepts of the perfect competition model as it applies to the rental market. It may not, in fact, be appropriate to model the rental housing market as competitive. Indeed, a policy model may have to incorporate market failure if it is to be useful.

At issue here are two categories of factors that may contribute to the failure of the rental market. The first category is the group of special characteristics of housing that can prevent it from functioning as a typical commodity. This is a group of factors largely <u>internal</u> to the dynamics of the rental market that may contribute in various ways and various degrees to rental market failure. The second category includes the broader macroeconomic and socio-political conditions in which the rental market must operate. This is a group of factors largely <u>external</u> to the dynamics of the rental market that may contribute to rental market failure.

The focus of the analysis is on the rental market rather than on housing in general. An assumption is made here that the impediments to a competitive market tend to be worse in the rental market than in the ownership market, largely because individual homeowners (and potential homeowners) are able and willing to spend the money necessary to, in effect, override the potential impediments. Homeowners tend to have a higher income profile than tenants, and homeowner households are more likely than tenant households to include two income earners. Obviously people with such advantages are in a better position than people without them to pay a premium in order to gain the intangible and tangible benefits of ownership, such as secure tenure and accumulation of tax-free equity. Other significant differences between ownership and rental tenure are developed in the discussion below.

The following subsections discuss some of the major characteristics of housing that tend to prevent housing, and in some cases rental housing in particular, from functioning as a typical market commodity.

High Transaction Costs. Transaction costs for housing are high relative to the equivalent costs for other commodities. Transaction costs, a widespread phenomenon in markets, are the costs incurred in acquiring a good in excess of its market price. In housing, these costs are significant. The buying and selling of housing involves advertising, agents' commissions, legal fees, and moving costs. In the rental market, transaction costs for the tenant include the costs of acquiring information about available units and neighbourhoods, the costs of searching for an apartment, and moving costs. For the landlord, transaction costs include the risk of vacancies, the costs of finding new tenants, the risk of bad tenants, and the costs of preparing vacated units for new

tenants. For markets to function efficiently, transaction costs ought to be negligible and the costs for buyer and seller should be comparable. High transaction costs discourage mobility and slow down the response to changing market conditions.

Tenants' demands for security of tenure and procedural due process guarantees can be attributed in part to these high transaction costs. Homeowners can generally decide for themselves when they want to incur the costs of moving, but tenants face the possibility of eviction.

High Capital Cost. Relative to other consumer purchases, a house, or rent on a house or apartment, is very costly. A substantial percentage of a household's disposable income is spent on this one item. Though the capital cost for a tenant is zero, the monthly rent paid must be sufficient to cover the costs and expected profits of a potential investor. High capital costs for investors translates directly into high rent levels for tenant households.

The problem of high capital cost is not the same for all households (whether the household purchases a house or purchases housing services through payment of monthly rents). On average, the lower is the household income, the higher is the percentage of income spent on housing. It is because of this relationship between income and housing expenditures that affordability is often referred to as an incomes problem rather than a housing problem. However one defines the problem, the fact remains that no other basic human need requires such a large capital outlay to produce. Yet because it is a basic human need, unlike many other commodities, housing must be produced. Everyone needs to be adequately housed. Households that do not have the down-payment and the long-term income stream to buy a house have no choice but to become

tenants. Most tenants are dependent upon rental housing investors, who must decide to build an adequate number of rental units when and where they are needed of a size (i.e., number of bedrooms) appropriate to the need.

In addition, because housing cannot usually be purchased (by potential owners) or built by most investors (for potential tenants) directly from income or even from accumulated savings, the high capital cost of housing has to be financed by borrowing money (i.e., by obtaining a mortgage). The operation of the housing market is, therefore, highly dependent on capital markets -- on the availability of mortgage financing and the cost of that financing (the mortgage interest rate). Changes in the finance market can have dramatic effects on the costs of new units and the level of building.

Heterogeneity of the Housing Stock. Few housing units are alike. Houses differ in age, size, repair, quality, amenities, and conditions of financing and occupancy. Each has different locational advantages. Each is, in effect, a slightly different commodity. Consequently there is no single market for housing but rather a very large number of separate though related markets.

In housing analysis, however, it is not possible to treat each housing unit differently. Housing units are treated as similar bundles of attributes, and it is the supply and demand for these generalized attributes that is analysed. Many of the complex yet highly significant factors that govern the decisions of consumers and investors must be assumed away. It is possible, to some extent, to deal with the heterogeneity problem through hedonic price indices (assuming that good indices can be compiled). With other, less complex goods, it is

possible to develop elaborate and fairly reliable analytic models and sets of research data.

As a characteristic of housing, the heterogeneity of the housing stock relates primarily to the difficulty of applying conventional market analysis to housing, rather than to some structural problem with the market itself. It is significant nonetheless, since most housing analyses, and therefore most housing policy recommendations, are based on the assumption that the conventional approach is an accurate and reliable tool for understanding housing.

Durability. Housing is one of the most durable consumer goods. Changing the stock when conditions change is very expensive. The ratio of new housing units completed each year to the total stock is usually in the order of only 2 or 3 per cent. The minority of new units produced each year has a variety of impacts on prices of the existing stock. These induced changes in prices can produce windfall gains for some groups and losses for others. Among other things, this possibility contributes to the political sensitivity of housing policy decisions. The decisions affect not only the stock being built but also the existing stock.

The implications of the durability of the housing stock are two-fold. First, we must consider the long-term consequences of short-term housing decisions, since we shall have to live with the effects of such decisions for a long time. The standard of new housing and the upkeep of existing units is of concern to future generations as well as to the one for which the houses are initially provided. Second, the stock of existing housing is an important element in the determination of housing prices and conditions. Few consumer goods that are basic

human needs have such durability and therefore such an impact on the existing supply of that good. Thus the durability of housing provides one rationale for the numerous land use and structural design regulations that have been imposed on the housing sector over the years.

Inelastic Supply. A further characteristic of housing that prevents it from functioning like other market commodities is the low elasticity (slow expandability) of supply. Housing supply responds very slowly to unanticipated changes in demand. When the market is left to itself, it will take a long time under even the best conditions to provide an adequate quantity of housing when and where it is needed. This delay is intrinsic to the building process, which depends upon a long and complex chain of activities. The decision must be made to build, land must be acquired, planning and design must be completed, zoning, development, and building permissions must be obtained, and financing arrangements must be completed before the actual construction can even begin. Depending on the size and nature of the project, construction can take from six months to two years.

Because it is impossible for the housing stock to respond quickly to increases in demand with new supply, any sudden change in the level of demand is likely to produce changes in the cost of housing and rents. In the absence of a "normal" market response to increased housing demand, it would seem that some form of regulation of the rental market is needed to stabilize rents. In addition, there is a need for some form of long-term supply planning, something that the market mechanism cannot provide. Government has introduced programs that subsidize the supply of new units largely in order to meet this need. Supply programs such as ARP, CRSP, and the social housing programs have

been counter-cyclical; that is, government subsidizes construction of units when, owing to broader economic factors, the market cannot produce them.

Fixed Location. Houses, unlike most other commodities, cannot be moved from one location or region to another in response to market conditions. A housing surplus in one area can, therefore, coexist with low vacancy rates, homelessness, and the occupation of inadequate housing in another. Thus the immobility of housing contributes to the inelasticity of supply: it impedes the market's ability to respond effectively to oversupply or excess demand.

Minimum Physical Standards. The numerous minimum standards regulations that apply to the production and maintenance of housing make it impossible to provide housing below a certain cost. Every unit must meet basic building, plumbing, electrical, fire, and design characteristics. Every unit must also be provided with a set of public services, ranging from physical services (roads, water, gas, etc.) to community services (access to schools, hospitals, etc.). Many other commodities are heavily regulated, but no other basic human need owes so much of its capital cost to the demands of regulation. This is another reason why market response, especially to the needs of low- and moderate-income households, is usually inadequate.

The basic standards are not limited to structural and safety features. In addition to being a basic human need, shelter is a primary cultural good. Everyone needs to obtain basic shelter for survival; in addition, everyone wants to achieve certain standards of comfort, design, and location. A cave will meet many of our basic physical needs

for shelter, but society has defined minimum standards for a housing unit that go well beyond meeting basic needs.

It is useful to compare housing with the other high capital cost good that most households purchase -- an automobile. Again, there are certain minimum safety and design standards that must be met. However, it is possible to buy used automobiles that meet these standards at extremely low prices. One must put up with a high probability of mechanical problems and be content with an unstylish vehicle, but people with low incomes can afford access to a used automobile and, therefore, private transportation.

Housing Services. Although people live in physical housing units, what they obtain from a unit is a range of services -- shelter, prestige, privacy, neighbouring amenities, access to community services, and, in the case of owner-occupied units, investment potential. These services are not, however, limited to the unit itself and its lot. They include the characteristics of the neighbourhood and its location. From most other commodities we seek a rather straightforward service. Though there are other complex goods and services on the market, few are more complex, with more numerous and diverse interdependencies, than housing. To recognize the complexity of the services provided by housing is simply to note yet another characteristic of housing that, when added to the others, compounds the problem of housing supply.

The Filtering Process. It is generally recognized that the private market supply mechanism cannot meet the demand for housing of lower-income households by direct construction of the required units. Very little, if any, of this demand can be met by new construction because the market cannot build units that lower-income households can afford

unless government provides fairly significant subsidies. In the current rental market, for example, the development industry's estimate is that the value of the subsidies required to produce even MURB and CRSP units, which generally rent at the upper end of the market, needs to be in the range of 25 to 30 per cent of total capital costs (Canadian Institute of Public Real Estate Companies 1982, 3).

The fact that the private market cannot provide rental units for lower- or even moderate-income households has not been defined as a market failure by conventional theorists, who assume that by an indirect process known as "filtering" the market mechanism can effectively meet this demand. Filtering would, in theory, generate a backward chain of movements when new units are built. As the new units are occupied, whole groups of households move upward and the housing situation in general improves. Thus an increase in the housing stock at the upper end of the housing spectrum is supposed to be beneficial to all households. In fact, there appears to be a wide gap here between theory and reality. British and American analysts have identified the four problems with the efficiency and equity of the filtering process.

First, an <u>inadequate volume</u> of units is being made available to the filtering process. There are many more lower-income households than higher income households. Yet, the market responds best, and often only, to demand in the higher income groups. As Boddy and Gray point out,

> One may question the volume of housing available to filter down to lower-income households. Since the distribution of household incomes tends towards a pyramidal shape, building new houses for those high up the pyramid will simply not release enough houses for those further down where the pyramid is wider. There are too few high-price and high-quality houses

> to meet the needs of lower-income households. (1979, 46)

It is unlikely that a rational development industry would overbuild at one end of the market, since the over-supply would only depress market prices.

The second problem is speed: to the extent that filtering takes place, how quickly do units actually filter down? Collard notes that filtering is, at best, a slow and protracted process:

> One could not expect rapid results from such a programme as the filtering process could be quite a protracted one, especially if there was already overcrowding in medium to poor type rented accommodation. The easing of the situation at the top of the housing scale would be blocked and therefore fail to trickle down to the really deprived groups. (1972, 171)

Thus the market mechanism could not, through the filtering process, meet an increase in demand among lower-income households very quickly.

Not only does filtering take time, but the units can get displaced on the way. The third problem with filtering is that breaks in the filtering chain can prevent whatever units may be available from reaching the lower strata of the marketplace. New households are continually entering the market to take up some of the supply, but in recent years this factor has been a less significant obstacle to filtering than the combination of demolitions, conversions, and gentrification. Many things can happen to a housing unit. In very tight markets, filtering is one of the least likely. According to Lansley,

> the main weakness of the filtering process is that... many of the vacancy chains are broken before the poor benefit to any significant degree. We have already seen that new building only adds 1 to 2 per cent at the most to the stock each year and there is evidence that such new private building has its greatest

> impact in improving the space occupied by the better-off and that little of the benefit is passed on to less affluent groups. Moreover, unmitigated, this process would simply lead to the permanent concentration of poorer households in the lowest quality housing and thus has indefensible distributional consequences. (1979, 25-26)

The fourth problem with the filtering assumption is that the units that do eventually filter down are often of poor quality, a circumstance that leads to the inequitable distributional consequences that Lansley refers to above. It is unlikely that the quality of a unit will remain the same, let alone increase, as it filters down. Serious deterioration in the condition of the unit is much more likely. The entire history of low-income households' living in unfit and substandard units demonstrates the shortcomings of the filtering assumption. Where filtering does take place, and it certainly has taken place in the history of many European and American industrial cities, the result is often the classic slum neighbourhood. It is not only the housing unit but the surrounding neighbourhood that must filter down before lower-income households can afford housing units on the private market. This is a process that R.U. Ratclirf described decades ago in his book Urban Land Economics:

> The end product of filtering, at the bottom of the chain reaction, is substandard housing; thus filtering produces the very blight which we seek to remedy. (1949; quoted in Boddy and Gray 1979, 47)

It is difficult, therefore, to assume that the market will supply units to lower-income households through the filtering process. There are no empirical studies of filtering in Canada, but the conceptual problems are sufficient to cast doubt on its effectiveness.

Boddy and Gray conclude their study of filtering with a sobering indictment:

> The concept of filtering is derived from a laissez-faire, market economy view of how the housing system operates -- or how it should -- and has in turn been used to support and legitimate this viewpoint in terms of public policy. The persistence of inadequate housing and of high status residential areas in the USA and UK, and the contradictory processes of "gentrification" and disinvestment by landlord and low income owners indicate the empirical bankruptcy of filtering as a general description of the housing system. The numerical insignificance of high quality dwellings, the effects of racial discrimination in the USA, and subsidies such as tax relief on mortgage interest and untaxed capital gains for home-owners in the UK all contradict the assumptions of the theory. The concept is theoretically unsound and hence of only limited empirical validity. (Ibid., 50)

Rental and Ownership Housing: Some Basic Differences. Rental housing and ownership housing share many of the same characteristics. To the extent that their characteristics differ, the differences tend to work to the disadvantage of rental housing. Some of these differences were mentioned in the above list.

What fundamentally distinguishes rental housing from ownership housing is the fact that rental tenure separates ownership from occupancy, creating a potential for conflict. The owner of rental housing becomes an investor in a good (accommodation) that can be treated like any other typical investment, while the occupant becomes the actual user of the good, with little or no concern for its investment aspect.

Home-ownership combines the two uses of housing -- that is, housing as a financial investment and housing as shelter, one of the fundamental human needs. Indeed, it is apparent that the home-owner,

unlike the renter, can overcome many of the problems that arise from the uniqueness of housing as a commodity, if he has the financial resources. The home-owner can, moreover, choose which aspect of housing he wishes to emphasize -- its investment potential or its use as accommodation. That is, he can decide what percentage of income to spend on housing (through his choice of housing, type, size, and location), what level of housing maintenance to sustain, and whether or when to move to another house.

The separation of ownership from occupancy creates the potential for conflict when the investment and occupancy interests differ. When a conflict arises in the rental relationship, who has the right to choose which interest should dominate? In Canada, up until the early 1970's, the decision was purely the prerogative of the owner. There was no balance of rights, responsibilities, or power in the landlord-tenant contract. Common law treated residential tenancies the same as it treated commercial and industrial tenancies.

Since then, governments have sought, in housing as in other areas, to eliminate abuse of basic rights on the basis of such things as race and sex and to protect consumers from misleading and arbitrary actions on the part of producers and owners. Intervention by regulation has focused especially on threats to basic human needs, such as good health and physical safety, and on threats to fundamental principles of justice and due process. Out of this evolution of societal institutions and practices, landlord and tenant legislation has emerged. In some jurisdictions, the control of actual rent levels has followed the adoption of landlord-tenant legislation because of the potential of economic eviction (i.e., the possibility that landlords will circumvent security of tenure regulations by significantly raising rents as a means

of evicting tenants). There is therefore an implicit, if not an explicit, societal recognition that there is something unique about rental housing -- something that separates it from the host of significant goods, including ownership housing, that we treat as normal market commodities.

External Constraints on the Operation of the Rental Market

The previous discussion identified at least some of the factors internal to the operation of the housing market that make it problematical to treat housing, and in particular rental housing, as if it were a typical commodity, either in terms of analysis (abstract theory) or in terms of policy and programs. Even if the problems internal to the rental market could be overcome, several external factors would alone likely provide significant barriers to its efficient operation. The five external factors discussed below are (1) inflation and mortgage interest rates, (2) post-war income transfer programs, (3) post-war housing programs, (4) the availability and cost of land for rental housing, and (5) the desirability of rental housing as an investment option.

Inflation and Mortgage Interest Rates. The general macroeconomic conditions of the past decade have been far from conducive to private rental investment. Inflation and mortgage interest rates in particular have disrupted investment patterns in the rental housing sector -- and in many other sectors of the economy as well. The long-term nature of the decision to invest in rental housing makes such investment especially vulnerable to the additional risks imposed by swings in costs.

In a recent report on the shortage of rental housing, the Canadian Institute of Public Real Estate Companies identified interest

rates as one of the major problems of the rental housing investment climate.

> These relatively high interest rates have caused serious disorder and instability to the rental housing market and industry. Construction and mortgage debt service costs have dramatically increased. Any new rental units would require alarming rental rate increases, whereas the tenant's disposable income and ability to pay is already seriously threatened. While these higher interest costs are certainly affecting all industries, financing costs are particularly a primary component in the rental housing industry. (1982, 8)

Although there have been no detailed studies of the impact of mortgage interest rates on private rental investment in Canada, we do know that the high and unstable mortgage interest rates have caused problems for house-builders and first-time house-buyers. In the past, analysts debated the impact of cost factors such as land, materials, and labour on the supply and affordability of housing. Since the early 1980's, these costs have seemed minor in comparison with the costs of financing. Even the interim financing costs associated with the purchase of land and the construction process have now become substantial components of total costs. The disappearance of fixed interest rates over the full term of the mortgage has contributed further risk to both rental and individual ownership investment decisions. As a result, financing costs have now been added to the factors affected by inflation, leaving borrowers with little ability to predict their actual medium-term, let alone long-term, costs.

For all its problems, the home-ownership sector has fared much better than the rental sector, largely because potential home-owners have higher average incomes and relatively more secure income streams than potential tenants. This means that on average the investor in

home-ownership is better equipped to deal with rises in financing costs than the investor in rental accommodation, whose income depends on the relatively low and insecure incomes of his tenants. If a rental-housing investor is to avoid this predicament, he must capture tenants from the small body of potential tenants with high incomes.

House-builders too have an advantage over rental-housing investors, since they can protect themselves to some extent from the impact of financing costs by selling units before they are built, a practice that has become fairly standard. Rental-housing investors have no such option. They must build for that portion of tenants able and willing to pay the rents necessary to finance the project, and they can have no reliable estimate of real vacancy rates in the initial months and years. In markets where the gap between existing rents and financial recovery rents is large, the likelihood of prolonged high vacancy rates after construction increases.

Post-War Income Transfer Programs. Macroeconomic conditions are not alone in contributing to the detrimental factors affecting rental investment and rental tenure. After several decades of the welfare state, with its numerous transfer programs, income distribution has changed very little. As Osberg points out in his recent book, Economic Inequality in Canada, this situation is quite surprising in view of all the social and economic changes that have occurred since the Second World War:

> This constancy of income shares since World War II should be something of a surprise, since a great deal has happened in the Canadian economy in the last 30 years. Real per capita personal income has considerably more than doubled, the labour-force participation of married women has more than tripled, the

> number of families composed of only one person has increased by roughly 40 per cent and, recently, inflation has played havoc with money wage rates and the returns from different assets. All these factors could be expected to affect income shares. (1981, 11 see also Moscovitch and Drover 1981, Poduluk 1980, and Ross 1983)

In the context of the rising real costs of new additions to the rental housing stock, many people simply do not have the income required to pay existing rents, let alone the rents necessary to make possible the building of new units on a financial recovery basis. If the number of lower-income households were fewer and relatively less poor, then the affordability problems in the private rental sector would be less severe. What our post-war welfare state has given to the poor through direct subsidy programs has largely been balanced by the numerous indirect benefits, given to the higher income groups through the tax system. Over the past fifteen years, inflation and inadequate funding of social programs have made progress in income redistribution even less likely. Long-term unemployment and under-employment will probably further exacerbate affordability problems among tenants and push some current home-owners into the rental sector.

The issue of incomes and the ability and willingness of tenants to pay the rents required for the private market mechanism to function is central to the question of whether the price and supply mechanism can properly function in the future -- that is, the question of whether the market is the solution or simply part of the problem. The recent literature on North American rental markets has been struggling with the question of lagging rental rates. In Canada, the blame is often laid on rent regulations, although, as Jones points out, "the phenomenon of lagging rents has been found throughout the United States as well even

though rent control has only been in existence in scattered cities" (1983, 6). In discussing the U.S. situation, Lowry concludes that the "great mystery of the rental market in the 1970's is why rents have increased so slowly" (1981, 36). In Ontario, average weekly earnings increased by 68.7 per cent between 1975 and 1982. Average rent increases in Metropolitan Toronto during the same period were slightly less: 63.6 per cent for bachelor units, 63.8 per cent for one-bedroom units, 61.0 per cent for two-bedroom units, and 65.5 per cent for three-bedroom units (Social Planning Council of Metropolitan Toronto 1984, 18).

A possible explanation for the lag in rents -- one that needs to be examined empirically -- is that rents in the marketplace tend to reflect a maximum general level that is based on a combination of economic criteria such as real wage gains and socially and culturally defined "acceptable" limits for rental expenditures. When rents rise above these limits, tenant households change tenure if they can (i.e., become home-owners); otherwise they double up or seek less expensive locations. It is certainly in their interest to organize and seek government intervention in the marketplace through the adoption or strengthening of rent controls.

By definition, the price of housing cannot exceed the resources available to pay for it. Incomes must be sufficient to pay for the full range of goods, including shelter. What this "full range" includes is both absolute and relative. Experts can define the absolute minimum necessities of life, but our culture tends to define the minimum much more broadly and in relative terms (relative to what most people have or hope to have).

It is interesting to note that the price trend in the ownership sector has been the reverse of the trend in the rental sector -- prices have outpaced incomes. This situation may be attributable to the increased prevalence of the two-income household (which reflects the growth of female participation in the labour force). The implication, once again, is that housing price changes reflect changes in the ability of the consumer to pay.

Reference to this hypothesis, together with some empirical data, can be found in Patterson (1978). Patterson describes the ownership situation in the following terms:

> Changes in affordability, defined here as the ability to afford a constant quality and quantity of housing, occur as a result of relative housing price changes and income changes. What we appear to have been witnessing in the past ten to fifteen years is a secular increase in housing prices. Regardless of the ultimate causes ... these price changes can be associated with rapidly rising family incomes and to some extent increased female participation in the labour force and the fact that the two-earner family has become a common occurrence. Those families with only one earner find themselves less and less able to afford a constant quality of housing. (1978, 292)

Discussing the rental sector, Patterson notes that

> although rents have increased much less rapidly than housing prices, approximating wage level changes as opposed to family income changes, even these less rapid changes comprise a burden for those with fixed incomes, most commonly the elderly. (Ibid.)

The hypothesis that rent levels have lagged because tenants perceive a threshold beyond which rents cease to be tolerable points to a major impediment to the provision of new supply through the operation of a private market. If the hypothesis is valid, then the cost of producing

rental units (the financial recovery rent) will continue to outpace the price obtainable in the market.

Post-War Housing Programs. Over the past few decades, our national and provincial housing policies and programs have very successfully "skimmed off" many of the renters able to pay financial recovery rents. Jones makes reference to this situation in his assessment of the rental market:

> Some observers link this apparently weak household income experience back into the lagging rental income and profitability concerns. Sternlieb and Hughes (1980) attribute the weakness in the rental market at least, in part, to the systematic "cream skimming" of relatively affluent male headed households from the rental market as they were induced into homeownership. In this view the rental market suffers from becoming increasingly dominated by households which have not had the economic success required to elect homeownership. This phenomena is alleged to have importantly contributed to a demand weakness which holds back rent increases and consequently discourages investment in rental housing. (1983, 9)

Numerous direct and indirect home-ownership subsidies have been provided in order to encourage as many households as possible to become owners rather than tenants. The total value of direct and indirect subsidies to potential and existing home-owners is far greater than the value of subsidies to tenants and potential suppliers of rental accommodation. Potential home-owners receive benefits under programs such as the Registered Home Ownership Savings Plan and under occasional provincial and federal programs that provide grants of several thousand dollars to each home-buyer. Existing owners benefit from the non-taxation of capital gains and imputed rent. The federal portion of home owner benefits is worth about $5 billion annually (Dowler 1983), whereas total federal and provincial benefits to the rental sector over the past

several years have averaged about $800 million annually; the total in 1983 was $1.3 billion (Arthur Anderson & Co. 1984).

The freeing-up of units by tenants who become owners has a significant positive impact only when rental demand is relatively low. Given the current high levels of demand and very low levels of supply, the overall impact is probably negligible. Estimates of these trends must take into account the phenomenon of deconversion -- the renovation of houses that were formerly divided into a couple of rental units into single-unit owner-occupied dwellings. This process is most common in the tighter inner-city markets, such as Ottawa, Toronto, and Vancouver. CMHC has estimated that over 8,000 units were lost to deconversion in Toronto between 1971 and 1976. The City of Toronto Planning Department has estimated the net loss at 5,000 units in the 1976 to 1979 period (City of Toronto, 1980). Because the units being lost most rapidly are likely to be among those with the lowest rents, deconversion explains at least part of the rapid loss of low-rent units on the private rental market. The deconversion phenomenon also points to how unrealistic it is to assume that downward filtering is occurring in markets where demand is very high.

We do not have careful studies of the net gains or losses that take place because of shifts from one type of tenure to another. These shifts can involve either the movement of households (e.g., the movement of higher-income tenants from apartments to houses and the movement of the elderly from houses to apartments) or the conversion of housing units (usually from rental to condominium or individual ownership). In addition to the possible net loss of housing through shifts of tenure, there is the definite loss of rental units through demolition and fire.

Post-war housing policy has also increased rental sector problems through the implementation of highly inefficient use of private sector subsidized supply programs (ARP, MURBS, CRSP). What "need" have these programs addressed and how have they helped improve rental market performance? The programs did increase the supply of units during the years they were in effect. However, some of the units would have been built in any case. For example, Lithwick (1978) estimates that about 40 per cent of the ARP units would have been built in 1976 without the generous subsidies provided by the program (see also Hulchanski 1982). Gau and Wicks (1982) have concluded that it is unlikely that the ARP and MURB programs were successful even in generating improved rates of return to investors because the benefits of these programs appear to have been quickly capitalized into land prices. The major point here is that the expenditure of public funds on subsidies to the private rental market has not helped the market function any better, either in the short term or the long term. In addition, most of the MURB and CRSP units are registered as condominiums to permit their conversion from rental to owner-occupied tenure when the conditions are right. These programs do not address the affordability problem, nor do they necessarily add a great deal to the long-term supply of rental stock.

Between our post-war incomes programs and housing policies we have, to some significant degree, designed and implemented programs that have either failed to relieve the problems of the rental sector or, in fact, directly contributed to those problems. These policy factors and their impacts on the rental market show no sign of changing.

Availability and Cost of Land for Rental Housing. It is difficult to have a healthy commodity market if one of the key factors in the

production of the commodity is generally not available where and when it is needed. Rental investment must compete with many other potential uses for a particular building site. If the land is not available at an economically feasible price, the rental project cannot be built. In recent years, rental housing has had to compete with a new force on the urban land market -- condominiums. A condominium investor can generally afford to pay a higher price for a given site than a rental-housing investor. If the developer already owns the site, he can receive a greater and quicker return by developing a condominium project rather than a rental project.

All of this assumes, of course, that the investor can obtain zoning for a rental project on the site. One of the impacts of the urban reform movement of the early- and mid-1970's has been to down-zone most of the desirable residential neighbourhoods in the larger urban centres. It is very difficult to obtain medium- or high-density zoning for rental accommodation in most parts of most cities. Single-family housing and multiple-unit owner-occupied housing (medium-density townhouses and condominiums) are the types of housing favoured by most neighbourhood residents and municipal councils. If the investor does obtain zoning for rental housing, he is likely to find that many of the more recent design standards set by the zoning regulations will push up costs and thus the required rents, reducing the number of tenants able to afford the units.

To the extent that government-subsidized housing-supply programs have resulted in capitalizing some portion of the subsidy in higher land costs, they have served to further discourage the potential rental investor. Even in periods of recession in the general real estate market, potential building sites for large residential projects

do not appear to have fallen in price by a great deal. Landowners tend to have long investment horizons and are often willing to sit on a site until market conditions change.

In short, the entire question of the availability and cost of building sites for rental accommodation is most vexed precisely in the markets where the demand is greatest. It is difficult to foresee any substantial change in community attitudes about rental-housing zoning and densities. Eventually, circumstances will compel change, but current attitudes are certainly an impediment to the functioning of private market supply and demand forces.

Rental Housing as a Desirable Investment Option. Many of the large development firms that built a great deal of the rental housing stock of the 1960's and early 1970's appear to have adopted investment policies that exclude future involvement in rental housing. A number of the large firms have also been selling off their huge portfolios of rental buildings. Many of these firms were originally established on the basis of residential investment. The problem is that other forms of real estate investment appear to have become relatively more lucrative. The Globe and Mail's 1984 review of corporate performance in the major sectors of the economy concludes that in real estate "the companies that have been profitable over the past two years have been those with the least exposure to raw land and housing" ("Report on Business 10/00", June 22, 1984, 45). The cost of financing residential projects -- high interest rates -- is identified as the major problem. According to the Globe, "the land and housing companies...were nearly wiped out by rising interest rates" (Ibid.).

It is difficult to have an efficiently functioning private rental market when the major and most experienced potential producers of the commodity find that it is not profitable to engage in such investment, even though demand is extremely high. In addition, it appears that such corporations are even better off if they sell off their residential holdings, since these holdings do not have the income-growth potential of investments in commercial real estate ventures. The Globe review concludes that the "pure income-property owners" have the best potential for profitability and that those corporations that have "decided to shed their residential business," in some cases even "dismissing them with a stroke of the pen to the 'discontinued' category," have been able to join "this preferred class" of successful development firms.

Rather than a form of investment for large firms and institutions, the Canadian rental investment market has increasingly become a sector in which individuals invest in ownership shares for purposes of income tax benefits. According to the Canadian Institute of Public Real Estate Companies,

> the feasibility of rental housing construction has been prominently based upon the sale of ownership interests to individuals particularly attracted by its income tax incentives, and not for retention and ownership by the developer. Rental housing operating returns are quite deficient as compared to the ownership of commercial projects where similar tax benefits are also generated to the developer. Rental housing is also considered more burdensome and risky to operate, subject to political controls and intervention. Accordingly, there really isn't any significant industry group which builds and owns rental housing for their own account. (1982, 12)

3.4 The Influence of Societal Goals on Housing as a Market Commodity

Even if "allocative efficiency" is achieved by a competitive market, this type of efficiency may not be a wholly satisfactory achievement. Exclusive reliance on markets, even when markets are performing relatively efficiently in the economic sense, can lead to the neglect of other goals that may be important to society. A particular allocation of resources, even when it is efficient, will usually only by accident accord with most people's sense of what is just or fair. A major example is income distribution. The actual distribution of income in a freely functioning competitive market system reflects its past: the system tends to perpetuate inequalities in the distribution of income and the ownership of assets.

Whereas economic efficiency can be defined and to some extent measured, equity, as an ethical concept, concerned with what people consider to be fitting or right, is much more difficult to define. The concept of equity has, however, provided much of the rationale for government intervention in the private sector. Equity concerns, which generally relate to certain minimum standards of "fairness" and "fair play," have been invoked by government to justify actions designed to

> achieve broadly based minimum standards of income, health and safety, education and so forth;
>
> ensure fair treatment before the law and social institutions in the sense of the consistent and impartial application of rules to all individuals, e.g., to treat persons in similar circumstances similarly;
>
> reduce the degree of inequality in the distribution of income, wealth, power, and social and economic opportunities;

> prevent "exploitation" of the unknowing or economically disadvantaged by the more knowledgeable and advantaged (e.g., the protection of minors);
>
> prevent economic transactions in what are regarded as personal, inalienable political and social rights (e.g., the selling of votes is prohibited); and
>
> reduce the impact of arbitrary or chance factors on the social and economic positions of individuals or groups (e.g., minimum standards for schools). (Economic Council of Canada 1979, 29)

Pressure on our elected representatives has led to government intervention in markets for a number of purposes, not the least of which is the achievement of greater relative equity (whether this is actually achieved or not is another matter). Equity is a "relative" concept and goal because the nature of the equity being sought is not static. It is rarely defined in any precise manner. The definition is a relative one, relative to what we have had in the past, relative to what we have at the present, and relative to our hopes and expectations for the future.

The Concept of Equality: Two Contrasting Policy Frameworks. While there seems to be very little debate about assisting the "truly needy", there is a great deal of debate over how far the state ought to go and what method it should use in addressing inequality when it comes to the provision of housing.

The most difficult issue in politics and public policy is the question of equality. As a society we support equality as a general principal. The private market does not claim to be equitable, but when a democratic government allocates resources it does so (or claims to do so), in many cases, on an equitable basis with a view to contributing to greater equality. What does this mean and how should we do it?

A useful way of approaching this fundamental issue is by referring to the categories of general and specific equality, or egalitarianism, as developed by Tobin (1970). Our society generally prides itself on being egalitarian, but this term means different things to different people. Our society accepts inequality in general, but tempers this inequality with "specific" egalitarianism. Specific egalitarianism, according to Tobin,

> is the view that certain scarce commodities should be distributed less unequally than the ability to pay for them. Candidates for such sentiments include basic necessities of life, health, and citizenship. Our institutions and policies already modify market distributions in many cases, and the issues raised by specific egalitarianism are central to many proposals now before the country. (1970, 264)

Through the years, a variety of basic goods and services have been regulated and often distributed on the basis of need rather than ability to pay. Health care and education are primary examples.

From the perspective of conventional economic analysis, however, most forms of specific redistribution are inefficient. As Tobin notes:

> The trained instincts of most economists set them against these policies and proposals. To the extent that economists are egalitarians at all, they are general egalitarians. The reason is their belief that specific interventions, whether in the name of equality or not, introduce inefficiencies, and the more specific the intervention the more serious the inefficiency. (Ibid.)

According to the view of general egalitarians, the proper objective of government policy, given the efficiency criteria, is to allow markets to work competitively. The proper use of the equality criteria is the examination of the overall distribution of income and wealth, not the specific distribution of any particular good or service. If critics do

not like the existing distribution they should, according to this view, attack general inequality rather than specific inequality.

The trouble with this view is that, though it may sound fine in theory, it is very difficult, if not impossible, to put into practice:

> There are pragmatic limits on the redistributive use of taxation and cash transfers. These instruments are not as neutral in their allocative effects as [some] appear to believe; they may seriously distort choices between work and leisure, selections of occupations and jobs, allocations of savings among competing investments, etc. We have yet to conjure into reality the economists's dream tax -- the lump sum tax no one can avoid or diminish by altering his own behavior. (Ibid., 265)

It is much more feasible to define some goods and services as "basic" and to see that each citizen receives at least the required minimum. There are, in addition, pragmatic limits on the redistributive use of taxation and cash transfers. The interests opposed to even minor steps towards a progressive reform of the tax and transfer system are formidable. We have failed to effect any redistribution of income and wealth during the several decades of the Canadian welfare state.

Tobin further notes that the general egalitarian approach of conventional economics rarely satisfies the intelligent citizen:

> The layman ... wonders why we cannot arrange things so that certain crucial commodities are distributed less unequally than is general income -- or, more precisely, less unequally than the market would distribute them given an unequal income distribution. The idea has great social appeal. The social conscience is more offended by severe inequality in nutrition and basic shelter, or in access to medical care or to legal assistance, than by inequality in automobiles, books, clothes, furniture, boats. Can we not somehow remove the necessities of life and health from the prizes that serve as incentives for economic activity, and instead let people strive and compete for non-essential luxuries and amenities? (Ibid., 265-66)

It appears that a great deal of the "social side" of the rental housing debate in Canada boils down to the difference between the specific and the general approaches to the question of equity. Though probably few would deny that general income redistribution is the better goal, it is a hollow goal given the realities of our social and economic system.

In a discussion such as this, it is important to make it clear that greater equity or greater equality as a long-term societal goal does not mean that everyone ought to be treated exactly the same as everyone else. In his classic book, Equality (1931), Richard H. Tawney made the distinction between differences in natural endowments of individual humans and the material differences arising from the way we choose to organize our society.

> So to criticize inequality and to desire equality is not, as sometimes suggested, to cherish the romantic illusion that men are equal in character and intelligence. It is to hold that, while their natural endowments differ profoundly, it is the mark of a civilized society to aim at eliminating such inequalities as have their source, not in individual differences, but in its own organization, and that individual differences, which are a source of social energy, are more likely to ripen and find expression if social inequalities are, as far as practicable, diminished. (Reprinted 1964, 56)

The obstacle to progress towards equality, according to Tawney, "is the temper which regards with approval the social institutions and economic arrangements by which such differences [in economic status and social position] are emphasized and enhanced, and feels distrust and apprehension at all attempts to diminish them" (ibid.).

Social Goals and Market Efficiency. The aim of this discussion has been to describe the reality of how our society seems to have approached the question of equity, rather than to argue a specific normative position.

The analysis of any specific issue as broad and complex as rental housing must recognize the realities of the context. Having done this, one can better design a strategy, if one chooses, for seeking change. This is how change occurs. First, however, the macro socio-political realities must be properly identified and assessed.

Part of the reality of how our society has treated housing in the past and how it will likely treat it in the future runs contrary to what is usually best for the efficient functioning of a competitive market. This is one of the constraints, external to the market, on the feasibility of a return to a freely competitive rental housing market. This constraint relates not only to the imposition of rent regulations but also to the growth of land use regulations that affect the availability of land zoned for medium- and high-density rental housing in our metropolitan centres. In addition, as our housing policies continue to favour the ownership option over the rental option, the rental sector will become, increasingly, a residual sector of lower-income households with a variety of social and economic problems; and this state of affairs will lead to even greater "interference" with the rental market mechanism by government in the name of the "specific egalitarian" approach.

PART II. POTENTIAL RATIONALES FOR RENT REGULATION

4. The Range of Rental Housing Policy and Program Options

Housing policy officials, faced with the inability of the private rental market to supply new units and with a large number of households that have difficulty affording rental housing, must consider the range of desirable and feasible options open to them. There is certainly no one perfect solution, nor is there likely to be any one static set of solutions. Owing to the need to learn from experience, making improvements as time passes, and to the changing economic and socio-political conditions in which the housing sector and housing policy must function, the set of policies and programs will have to evolve and be dynamic.

Some of the various measures will likely have to be the second best options, given the broad and complex context in which housing policy must operate. The perceived first or best choice among the options may not be politically or economically feasible. Trade-offs will continue to be made, as they have been in the past, between options that may be efficient in terms of private market performance and options that address social and political objectives. It is unlikely that housing policy, especially rental-housing policy, will ever be decided upon without a great deal of lobbying and controversy. There are simply too many trade-offs to be made, and it will be a rare policy choice that maximizes the interests of all groups.

4.1 The Range of Options

There is a broad range of general instruments that government can use to influence economic behaviour and achieve social goals. The Economic Council of Canada has defined the major categories as follows:

- Exhortation, Negotiation and Moral Suasion (e.g., ministerial speeches, conferences, affirmative action, the creation of advisory bodies and task forces to study a problem, and threats of government action);

- Direct Expenditures (e.g., both capital and current outlays for the provision of public services, grants, subsidies and transfer payments);

- Tax Expenditures (i.e., the use of tax exemptions or incentives when the cost is measured in terms of revenue foregone);

- Taxation (i.e., direct and indirect taxes, fees or prices for public services, contributions to compulsory pension plans or insurance schemes);

- Public Ownership (e.g., direct publicly owned and managed as well as joint ventures in which the government is the controlling partner); and

- Regulation (e.g., all forms of statutes and legislation establishing regulations, directives, guidelines and the like).

(Economic Council of Canada 1979, 43)

In the rental sector, government has used a combination of public ownership, direct expenditures, tax expenditures, and regulations.

Direct public supply and ownership of housing took place during the wartime conditions of the early 1940's through the Crown corporation Wartime Housing Ltd. and during the 1950's and 1960's through the public housing program (Dennis and Fish 1971, Rose 1980, and Wade 1984). Direct expenditures, mainly through the annual budget of CMHC, have subsidized public and private sector housing and the nonprofit housing programs as well through a variety of techniques, including direct lending, capital grants, subsidized mortgages, and interest-free loans (CMHC 1983). Indirect subsidies, or tax expenditures, have been provided through special provisions of the tax system for such things as special soft cost deductibility and capital cost allowances and the MURB program (Canada, Department of Finance 1981, Dowler 1983). Regulation, the oldest and most extensive form of public intervention in rental

housing, started with turn-of-the-century public health, safety, and fire regulations and added through the years zoning, land use, and now rent regulations (Hamilton 1981, Hulchanski 1981).

The current rental housing debate generally centres on three of the options -- direct expenditures, regulation, and tax expenditures. The direct expenditure debate emphasizes the rival claims of supply subsidies (through, for example, the nonprofit housing programs) and demand subsidies (through, for example, a shelter allowance program). The regulation debate is largely over certain types of land use regulations and, as well, the nature -- and indeed the existence -- of rent regulations. The bulk of tax expenditures go to the ownership sector, but there has been lobbying by the development industry for greater rental sector tax benefits. Public ownership does not have a great deal of support, though municipal governments and social agencies do favour some revived form of small-scale public housing program in order to better address the needs of the very poor and homeless (see, for example, Association of Municipalities of Ontario 1981, and Social Planning Council of Metropolitan Toronto 1982b, 1984).

The present chapter considers the regulatory option at the conceptual level. Chapter 5 then discusses the potential rationales for the rent regulation option.

4.2 The Regulatory Form of Intervention

What is regulation and why is regulation as widely used as it is criticized? The Economic Council of Canada, in its report titled Responsible Regulation, defines economic regulation as "the imposition of constraints, backed by the authority of a government, that are intended to modify economic behaviour in the private sector

significantly" (1979, 43). Government regulation of the private sector usually acts to modify one or more of the following: price, supply, rate of return, disclosure of information, attributes of a product or service, methods of production, conditions of service, and discrimination. Each regulatory instrument can be deployed in a variety of ways and has .cp 3 associated with it a number of attributes, including economic costs and benefits, political costs and benefits, and a given degree of coercion.

The Economic Council notes that governments tend to reach for the regulatory instrument before any of the other options. This is because

> under current conditions, the political cost of using the regulation instrument appears to be lower than either taxation, direct expenditures or public ownership. A government's budgetary costs of administering even a pervasive and stringent regulatory program are usually small. For example, the total budgetary cost of all federal regulatory programs amounts to less than 2 percent of the total federal budget. The far greater cost of compliance with regulation is borne in the private sector by shareholders, consumers and workers. These latter costs will usually not be apparent at the time the regulatory program is imposed. (Ibid., 44)

Most studies of regulation note that there are two broad categories or types of government regulation: (1) direct (sometimes referred to as "economic", "old", or "traditional" regulation) and (2) social (or "new", or "health, safety, and environmental" regulation). This is an important distinction because usually both the objectives and the techniques of the two types of regulation are different.

Direct regulation is industry specific, affecting one or more of the following: the price or price structure of a good or service,

the rate of return, entry, exit, and output. Rent regulation generally affects the price charged and the rate of return allowed. Consequently, rent controls fall into the category of a broad range of socially imposed price and rate-of-return regulations, including wage and price controls and regulations that affect telephone and utility rates, taxi fares, the prices of goods sold through marketing boards, airline fares, and pipeline tariffs. A significant proportion of total economic activity in Canada is subject to one or more of the direct forms of economic regulation.

Social regulation embodies a broad set of social objectives in regulations that go beyond specifically economic criteria. The regulations are still economic, but the approach is different. Social regulations affect the physical characteristics of goods and services and the conditions under which they are produced and sold. This category includes regulations related to health and safety, environmental concerns, "fairness," consumer protection, and cultural content.

The major categories of social regulation in use in Canada are (1) regulations requiring the disclosure of information about the attributes of a good or service (quality, purity, safety, availability, durability), (2) regulations affecting methods of production and conditions of sale or employment (minimum wages, hours of work, holidays), and (3) anti-discrimination laws (relating to employment, accommodation, and the sale of goods and services).

Rent regulations fall into the category of direct regulation. The owners of residential rental properties are constrained by rent regulations from independently setting rent levels and from doing other things with their residential rental property. The focus of rent regulations is on the direct control of price and conditions of exit for

one industry, rental housing. Security of tenure rules are ancillary to the price constraints. They go hand in hand with the controls over demolition and conversion to non-rental status (e.g., condominiums) or non-residential uses (e.g., commercial uses). Demolition and conversion controls protect security of tenure by controlling exit from the rental housing industry, just as rent controls protect security of tenure by preventing economic eviction.

Rent regulations do not directly block entry to the private rental sector, but they do have an indirect impact on entry to the extent that they cause rental investment to become or appear to become less attractive relative to other potential investments. Other regulations, such as zoning bylaws and related community planning measures, can directly block entry to the private rental sector in some neighbourhoods by not permitting residential rental land uses or the densities necessary to make rental investment attractive. It is important to note, however, that how much housing is built depends not only on these regulations but on factors such as the general health of the economy, demand within each community, and government housing programs.

4.3 What Influences the Choice Between Alternative Options?

Since it is elected officials who decide what is to be done about issues of public concern, it is important to understand the constraints under which politicians, and the policy advisors who recommend courses of action to politicians, choose the form that intervention is to take. The conclusion of a study prepared for the Economic Council of Canada is that, like it or not, "the present calculus of instrument choice" in Canada is "dominated by the search for electoral success rather than 'efficiency' considerations" (Trebilcock et al. 1982, 101, 103).

A related report lists fourteen "axioms" about the specific constraints on how choices are made, drawn from an analysis of how and why different choices were made in the case studies examined. Among the fourteen are the following seven:

- It is in the interests of a governing party to choose policies which confine the benefits to marginal voters and confine the costs to infra-marginal voters.

- In order to overcome the information costs faced by marginal voters, it is in the interests of a governing party to choose policies which provide benefits in concentrated form so that their visibility is enhanced and to impose the costs in dispersed form so that their lack of visibility is enhanced.

- A governing party cannot choose only policies which provide highly concentrated benefits, because as the benefits become more clearly visible, the smaller the group of voters on which a party can realize a political return.

- It will be rational for a governing party to treat highly concentrated or well-endowed interest groups as marginal voters to the extent that they possess an ability to provide (or threaten to provide) subsidized, selective information directly to marginal voters that might change their political preferences or to provide resources to the governing party which it can in turn either confer benefits on marginal voters or provide subsidized, selective information to marginal voters intended to influence their political preferences.

- In order to secure the co-operation of bureaucracies in implementing policies, a governing party is likely to attach special weight to the views of bureaucrats in formulating policies. Bureaucrats in advocating policies to their political overseers will have a tendency to favour policies which have a heavy bureaucratic orientation, entailing more jobs, larger fiefdoms and more power and prestige.

- Where a governing party is uncertain as to the impacts of alternative policy instruments on marginal voter interests or on marginal voter awareness of these impacts; the intensity of voter preferences surrounding these impacts; or opposition parties' alternative policy proposals on these issues and voter responses thereto; it may be rational to choose an instrument that maximizes reversibility and flexibility, so that continuous marginal adjustments in the balancing of interests can be made over time.

- Recognizing the limited investments in information about policy issues that most voters are willing and able to make, the media will often tend to trivialize complex policy questions both in

> identification of the issues and in proposed prescriptions for their resolution. This may often involve advocacy of simplistic collective policy responses to perceived matters of public concern so that stories can be turned over at a sufficient rate to retain the public's attention. Because the public may be influenced by this advocacy, politicians may also be compelled to attach weight to it. (Trebilcock et al. 1981, I-1 to I-10)

These axioms, and others among the fourteen in the list, provide a realistic description of the policy-making process as it exists in Canada. Many factors come into play. Rational arguments and empirical evidence may or may not be influential in the end.

This should not be viewed as a cynical assessment, nor should the process described necessarily be judged as wrong or bad. Different sets of assessment criteria are being brought into play. Even where the assessment criteria are similar, they are often weighted differently. Housing policy analysis needs to adopt more of a "political economy" approach, broadly defined, rather than focusing on narrow sets of criteria, whether they consist of social concerns or economic impacts on markets. Behn makes a very useful distinction in his article "Policy Analysis and Policy Politics". In the current public policy arena, Behn finds two principal players: policy analysts and policy politicians.

> Policy Analysts. The policy analysts are concerned with economic efficiency, with how public policies affect society as a whole. They emphasize explicitly defined policy objectives and conscious tradeoffs between competing objectives. They seek clear measures of outcomes -- of how successfully these objectives are being realized. With a faith in their analytical techniques, the analysts draw their policy recommendations from abstract, mathematical models. (1981, 199-200)

> Policy Politicians. The policy politicians are concerned with distribution, with how public policies affect individuals and groups. They emphasize negotiation, bargaining and compromise, and the obscuration of competing objectives to achieve

> consensus. They seek the resolution of conflict between competing interests -- the allocation of limited resources between such interests. With a faith in the political process, the politicians draw their policy recommendations from the intensity of their constituents' views. (Ibid., 200)

Because economic rationality and political rationality often conflict, the practice of policy analysis cannot ignore this conflict. It is part of the process. "Selecting public policies, and getting them implemented," according to Behn, "requires repeated iterations between the analytical and the political" (ibid., 225-26). It is, therefore, not unreasonable for citizens to be suspicious of both the analyst and politician, the former for allowing efficiency to dominate equity as an analytic value and the latter for paying too much attention to the parochial aspects of the distributional issues in making the ultimate decisions.

Rent regulation is an interesting example of the conflict between concerns about economic efficiency on the one hand and distributional equity on the other. The following chapter discusses the potential rationales for the regulatory form of intervention in the rental market.

5. The Potential Rationales for Rent Regulation

If the rental market were functioning efficiently, or seemed likely to function efficiently in the near future, and if we as a society agreed with the way in which the market determines what is efficient and equitable, there would be no rationale for rent regulations. The rationale for rent regulations rests on two present conditions: the failure of the private rental market to function and the societal definition of criteria relating to rental housing broader than simply "economic efficiency" as it is defined and operationalized by the housing market. Both of these conditions have evoked a response from politicians, and the result has been the imposition and maintenance of Ontario's rent review system.

There is substantial evidence of the failure of the rental market to function normally at present, and the points raised in this study indicate that it is unlikely to function efficiently in the foreseeable future. It is also highly unlikely, given the past and current attitudes of the public and its elected representatives, that many people would find the allocative and distributional impacts of a freely functioning rental market acceptable.

Under these conditions, there is a general rationale for the imposition of rent regulations aimed at achieving a number of ends that would otherwise not be achieved. The exact nature of the set of regulations must evolve, for there is not and cannot be one static, ideal set of regulations. The context in which the regulations are set is continually in flux, and we are, one hopes, continually striving to improve the effectiveness and equity of any set of regulations that we impose as a society.

However, no set of rent regulations can solve the rental housing problem. Regulations can only achieve certain limited ends; that is, they can prevent some aspects of the rental situation from growing worse and enforce certain basic precepts of justice and equity in the landlord-tenant relationship. More specifically, a carefully designed and equitably administered system of rent regulations can do the following: (1) improve security of tenure, (2) maintain the affordability of the existing rental stock, (3) prevent a regressive redistribution of income in tight rental markets, and (4) mediate conflicts over rental tenure.

Regulations are not always the best method of achieving desired ends. Given the feasible range of alternatives, however, rent regulations do appear to be a most reasonable and practical means of achieving the above four ends. If the rental market were functioning, one could produce a host of arguments about the impact of regulations on a competitive rental market in equilibrium. Such exercises are purely academic, given the current state of Canada's rental market and the external social, political, and economic forces acting on the rental market. For the foreseeable future -- that is, the rest of the 1980's -- high real interest rates, inflation fears, and a low level of rental housing supply subsidy programs because of government budgetary constraints will leave a gap between financial recovery rents and market rents.

5.1 Security of Tenure

Only in 1970 did Ontario substantially alter the legal doctrines affecting the landlord and tenant relationship. Until that time, a contract in the legal sense did not exist. In common law, the landlord-

tenant relationship in the rental market was a property one, similar to a lease creating an estate in land. The landlord was under no statutory requirement to even maintain the premises, nor were there limitations on the landlord's power to evict, change locks, seize tenant property, and so on. The landlord and tenant legislation moved the relationship between the two parties from its feudal origins in common law to a statutory basis in modern contract law. This move did not create security of tenure as such, but it did create the rationale for it (Makuch and Weinrib 1984).

This rationale boils down to a societal definition of what is fair and unfair in the landlord-tenant relationship. Most important things in society are regulated, and Ontario's landlord-tenant legislation introduced regulations that sought to enforce certain reasonable expectations of society about what this relationship ought to be. What is "reasonable" in a democratic society is defined, in the end, by the political process and enforced by legislation. In Ontario's case, the Landlord and Tenant Act that came into effect on January 1, 1970 included the following provisions:

- the introduction of contract principles into residential tenancy law;
- the requirement for landlords to repair and maintain residential rental property;
- the requirement that a tenant be given a copy of the tenancy agreement;
- the provision that a landlord could regain possession only under the authority of a court writ of possession and that a landlord could not evict a tenant without a court order.

The act essentially provided new legal procedures for eviction rather than security of tenure, though the two are closely related.

Through the early 1970's, changing attitudes and changing legislation led to both increased security of tenure provisions and a greater recognition of the rights of tenants. As the Ontario Law Reform Commission noted in 1968, there was such a wide disparity of bargaining power between the landlord and tenant that the "contract" was one-sided, leaving tenants with virtually no rights:

> The landlord and tenant relationship is not, if indeed it ever was, one where tenants have a real freedom to contract. Traditional statements which maintain that a tenant need not agree to the leasing covenants but can seek agreement on more suitable terms elsewhere are not borne out by what happens in the real world of landlords and tenants.

By 1975, amendments to the Landlord and Tenant Act had provided for greater security of tenure by, for example, preventing landlords from withdrawing vital services (i.e., utilities) in order to circumvent eviction procedures. Section 107 (4)(b) of the 1975 amendment provided a further general protection for security of tenure. The amendment stated that a landlord cannot:

> substantially interfere with the reasonable enjoyment of the premises for all usual purposes by a tenant or members of his household with intent to cause the tenant to give up possession of the premises or to refrain from asserting any of the rights provided by the tenancy agreement.

In short, as society's view of the landlord and tenant relationship changed in the 1960's and 1970's, Ontario's legislation, and that of the other provinces as well, began to reflect the change. The law was gradually catching up with society's view of what is fair and reasonable. This process cannot be seen as a wresting of property rights from the landlord, because such a view assumes that there is some

socially defined agreement about what the property rights of a landlord are. Security of tenure regulations fall into the same category as the socially defined reasonable regulations that govern zoning, land use planning, health and safety of the structure, demolition, and conversion. They fall as well into the very broad category of consumer protection regulations, which govern goods and services of many kinds. Most contractual relations in our society are regulated. Regulation of the landlord-tenant contract is, therefore, not unique, even though it may be of fairly recent vintage. The aim has been to achieve a fairer balance of rights and obligations between landlords and tenants (Makuch and Weinrib 1984).

The introduction of rent review in 1975 necessitated further extension of security of tenure in order to prohibit the circumvention of rent review. Rent review, in fact, helps prevent the circumvention of security of tenure provisions. They go hand in hand.

Questions about security of tenure are unavoidably intertwined with the question of rent control because of the possibility of economic eviction. When Ontario's initial landlord and tenant legislation was adopted, it was recognized that the security of tenure that a tenant might enjoy as a result of the legislation could be put out of reach by a large increase in rent that the tenant was unable to afford. As the Ontario Law Reform Commission pointed out, "the prime purpose of rent control is to make it possible for tenants to find and keep decent apartments at reasonable rents." A model tenant against whom no complaint is likely to be made can be dislodged by a rent increase more easily than an undesirable tenant can be evicted for cause. This is a

problem that can be solved, it appears, only by the institution of a rent control system.

Security of tenure, therefore, requires two kinds of regulatory protection: regulations that govern the conditions of tenancy, especially the reasons for and the manner in which tenants may be evicted; and protection from economic eviction. In Ontario, the former sort of protection is found in the Landlord and Tenant Act and the latter in the Residential Tenancies Act.

Regulation of the rental contract that was limited to eviction protection and did not include controls over rent increases would fail to provide basic security of tenure. Security of tenure regulations must be accompanied by rent regulation, one form of which is rent review, in order to prevent landlords from circumventing the regulations by forcing out or evicting tenants who refuse to pay inordinately large rent increases. The same reasoning applies to the need to accompany rent regulations with conversion and demolition controls.

Because of the special characteristics of housing, and in particular rental housing, defined earlier in this study, the rental market cannot by itself guarantee tenants those rights and basic protections which society has deemed reasonable and fundamental. Thus, rent regulations that affect security of tenure can best be viewed as a form of consumer protection. Where the rental market cannot function normally, such as in meeting supply, or when moving costs limit the mobility of the consumer of rental services -- to cite just two examples of problems -- regulations protect consumers who find themselves in an inferior bargaining position. Groups in inferior bargaining positions in a market quite naturally turn to government for protective regulations. Government, in effect, creates a countervailing power in the

marketplace. Once such a countervailing mechanism is in place, even if it is called "temporary," it is often very difficult to remove except at great political cost.

A related way of understanding the origins of the popular demand for this "consumer protection" element of rent regulations is provided by Owen's and Braeutigam's characterization of voters as being "risk avoiding". In the face of uncertainty and rapid change, people seek mechanisms for preventing the possibility of negative outcomes even at the expense of some efficiency loss. Most people voluntarily purchase insurance to cover a variety of potential losses (risks), such as a house fire, serious accident, or untimely death, even though the loss is remote (not highly probable). Insurance does not prevent the loss or decrease the risk, but it does at least provide financial compensation. In their widely quoted study of "the regulation game," Owen and Braeutigam conclude that:

> a major effect of the administrative or regulatory process is to attenuate the rate at which market and technological forces impose changes on individual economic agents; it is rational for voters to prefer such a mechanism for avoiding risk to a laissez-faire market system, even at the cost of some efficiency loss. The administrative process is "fairer" than the ungoverned market because it imposes due process requirements on any change in the existing set of goods, prices, and market structures. The result is to give individuals and firms some legal rights to the status quo. (1978, 1-2)

Insurance is not very practical for tenants but government regulation is. This helps to account for the great deal of support one generally finds in opinion polls for rent regulations. Not all tenants have "bad" landlords seeking to extract the last penny. It is the fear in very

unstable times that even something as fundamental as one's "home" may be insecure that makes rent regulations attractive to numerous voters.

An interesting parallel is the insecurity caused in the home-ownership market by unstable mortgage interest rates. In this case, the government response to voter pressure has been both insurance -- the Mortgage Rate Protection Program announced in the February 1984 federal budget -- and further mortgage industry regulations. The finance minister announced that his "government is sympathetic to the plight" of home-owners:

> The volatility of interest rates we have experienced, and the impact this has had on individual Canadians, have led the government to consider ways in which stability of mortgage costs could be enhanced and consumers' rights strengthened. (Canada, Department of Finance 1984, 2)

Tenants seek protection from the impact of fluctuations in the rental market, protection that includes additional statutory rights when they bargain with their landlords; by the same token, home-owners have sought and obtained protection from fluctuations in mortgage interest rates, protection that includes additional statutory rights when they bargain with their mortgage lenders.

5.2 Maintenance of the Affordability of the Existing Rental Stock

Rent controls were first used in many countries during emergency situations, usually wartime (Willis 1950). The rent levels that resulted from the emergency conditions, which limited the supply of new rental units and increased demand among the existing stock, became politically unacceptable. Government intervened until the general conditions permitted the rental market supply and demand mechanism to function more

normally. This temporary form of rent regulation designed for national emergency situations is often referred to as "first generation" rent control.

The "second generation" of rent regulations, imposed in the 1970's, also seeks to protect tenants from inordinate rent increases. When increased demand is not met by increased supply, prices increase. The owners of existing units are in a position to charge what the market will bear. In a normal commodity market, increased prices provide a signal to investors that results in increased supply, which returns the market to equilibrium.

Second-generation rent regulations seek to prevent the owners of the existing supply of an increasingly scarce commodity from exercising their economic power by earning what are deemed by many to be unfair or windfall profits. The unrestrained operation of the rental market allows the owners of the existing rental stock to gain financially from the problems of the rental sector.

One fairly common problem in unstable times is the short-run inelasticity of demand for rental housing. When the costs of most other commodities rise, one can delay purchase, substitute alternative goods, or consume a smaller quantity or an inferior quality of the good, but, it is difficult to suddenly begin consuming one less room or so many fewer square feet. In other words, demand for most commodities can adjust quickly to rises in cost, but it is not possible for rental-housing demand to adjust very quickly or easily if rents rise substantially in the short run.

Consequently, one of the rationales for rent regulations is the aim of decreasing the occurrence of sudden, abnormal, and "unfair" rent increases in times of limited rental vacancies, in times of general

inflationary pressures on all sectors in the economy, and in times of extreme speculative pressures in the land market and the urban development market. Since the late 1960's, all three of these conditions have prevailed in many of the larger urban areas.

Even if the rental market were functioning better, there would still be the problem of the inelasticity of supply. Over the past decade, however, the private rental supply mechanism has been more than simply inelastic: it has not operated adequately on its own. Under such conditions, market pressure on the owners of the existing rental stock to raise rents becomes irresistible.

One of the misconceptions about the rationale for rent regulations is the belief that they are intended to alleviate housing affordability problems. Rent regulations do not and cannot lead to the supply of additional housing, especially affordable housing. Nor can they necessarily "alleviate" housing affordability problems. Such a claim implies that the regulations adjust rents among the private rental stock to the incomes of households with affordability problems. However, second-generation rent regulations do not include such an adjustment mechanism. They do not even arbitrarily freeze rents. Ontario's system permits rent increases that often exceed the rate of inflation, the growth of real average tenant household income, or some other such general economic measure.

The rationale in terms of affordability is to prevent the existing stock from becoming increasingly unaffordable. This is achieved by preventing the rate of increase in rents that would otherwise result when the market supply and demand mechanism fails to operate normally. The regulations constrain the rate of increase in

rents to base itself not on demand pressures but on other, non-market criteria, such as operating costs. To the extent that rent regulations have kept rents down, below levels they would otherwise have reached, it has helped a number of lower-income households to at least maintain their access to housing that is somewhat more affordable, given the severe problems of the rental sector. The regulations are by no means "alleviating" the affordability problem of tenants. They are simply preventing affordability problems from getting worse for at least some tenants.

5.3 Prevention of Regressive Income Redistribution

To the extent that rent regulations have kept rents at levels lower than they might otherwise have reached, they have helped prevent a regressive redistribution of income. If rents were to rise simply because the market is unable to function normally, the owners of rental accommodation would benefit from their unique market position as owners of a scarce commodity that is not only in high demand but also a basic necessity.

This rationale for regulation is aimed at preventing or minimizing redistributive changes deemed to be unfair or unreasonable in a situation in which the market mechanism is not functioning normally. Rent regulations seek to prevent the exercise of market power to earn excess profits, which would mean a redistribution of income from tenants to the owners of rental accommodation. While not all tenants are in the bottom two or three quintiles and not all landlords are in the upper one or two quintiles in terms of income and wealth, on average tenants are less wealthy than landlords.

Another common misconception about the rationale for rent regulations is the belief that they are intended to achieve the redistribution of income. The prevention of a regressive redistribution threatened by unusual circumstances is quite different from the achievement of a progressive redistribution. It is one thing to prevent things from getting worse by maintaining the status quo and quite another to achieve a meaningful change in the status quo.

The attempt by opponents of rent regulation to define them as a tool for income redistribution assumes that there is some natural or moral right to the maximum possible return on investment, as opposed to a lesser return deemed "fair" or "reasonable" by regulations. It also assumes that the market is functioning normally and that the market determination of rents in the absence of rent regulations would be equitable under current conditions. The rental industry is not the only industry in which price is regulated. However, regulation of the rental industry is of recent vintage, so it is understandable that estimates of what would have been earned in the absence of regulations are being defined as a redistribution from landlords to tenants. If the rental market were functioning efficiently and government decided to use it for redistribution purposes, then the arguments about the redistributive impact of rent regulations would apply.

By most standards, rent regulations would be a blunt and unfair tool for achieving an improved redistribution of income in society. Rent regulations arbitrarily assist all tenants covered by regulations, no matter what their incomes. Moreover, rent regulations designed to accomplish redistribution of income would operate at the expense of one class of citizens, the owners of rental accommodation. Claims that redistribution is currently taking place must assume that owners of

rental accommodation are being denied something to which they have a natural right -- that is, the rent levels achievable in the absence of rent regulations. By this standard, every industry in which prices are regulated, which is most industries, can make the same claim. By this standard, many industries are redistributing wealth via a blunt instrument in a fashion that is horizontally and vertically inequitable. What is the significance of such analysis, apart from a political one?

The other side of this line of reasoning implies that there is some ideal mechanism capable of redistributing income in a non-blunt, perfectly equitable fashion, and that it is both desirable and possible to eliminate blunt and inequitable redistribution in every instance in which it takes place. A perfectly progressive income tax is perhaps the ideal, but we are far from that ideal. We are even further from rooting out all actions regarding which the claim can be made that inequitable redistribution is taking place. One thing we can easily identify and root out if we choose are attempts to use blunt instruments such as the regulation of one industry for the direct purpose of redistributing income. However, it is a different undertaking, with different impacts, to regulate an industry in order to prevent it from using its market power to obtain unfair advantages or returns.

In part, the issue here seems to come down to an approach to the subject in the narrow context of market allocation. Non-market allocation is deemed almost by definition to be inequitable, whereas market allocation is not subject to this judgement because it is somehow neutral. It is difficult to see how this distinction is anything but a political (normative) defence mounted by those who wish to retain their market position against the messy processes of a democracy that is

defining for itself a better way to manage and allocate resources. This does not imply that regulation is, by definition, a better way. Mistakes can be and are made.

It should be noted that recent research has found that some regulated industries are the beneficiaries of regulation, rather than the consumers. It is wrong to assume that regulations are a one-way street. In the case of rent regulations, the evidence is not yet in. Rent regulations allow for certain levels of annual rent increases, something the market itself does not guarantee. A second-generation rent regulation system should allow a fair and reasonable return to the owner of rental accommodation. By adopting rent regulations in the first place, our society has placed a "value judgement" on the issue of fair versus unfair returns under unstable market conditions. The problem is to define what is fair and reasonable -- a political problem to whose solution experience, debate, and lobbying all contribute.

5.4 Mediation of Conflicts Relating to Rental Tenure

Value conflict and its resolution is an important element of a pluralistic society in which different interests hold a multiplicity of goals and objectives. In such a society, there may be vastly different perceptions of a problem, its characteristics, and its solution. Both sides can look at the same empirical data and draw wholly opposite conclusions. This is unavoidable.

Conflicts between goals and objectives involve the promotion of fundamental values and value positions. These underlying values are often implicit, rarely stated or even clearly understood. When there are conflicting value positions, a process of negotiation or bargaining is often necessary to resolve the issue. If the parties cannot resolve

the conflict themselves, government is required to play a mediating role.

In the case of rent regulation, our democratic society, through the elected government of the day, is called upon to mediate between conflicting bundles of rights. "Rules of the game" are established (i.e., legislation and regulations) in order to make potential conflict situations matters of routine procedure to which both sides must adhere. This arrangement protects the rights and enforces the responsibilities of both sides. A great deal of this protection can be achieved through security of tenure provisions, without rent regulations; it is the very contentious issues associated with rent levels and changes in rent levels that rent regulations address. The most fundamental element of the landlord and tenant relationship is the rent itself. It is the existence of rent regulations, not simply landlord and tenant legislation directed to security of tenure issues, that begins to establish a more balanced power relationship between the two parties. Only through rent regulations is the most important issue in the landlord and tenant relationship, changes in rents, negotiable before a public commission via established rules and procedures.

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